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STATE OF MONTANA

DEPARTMENT OF BUSINESS REGULATION
BOARD OF MILK CONTROL

REPORT ON THE NEED FOR MILK PRICE REGULATION IN MONTANA

December, 1976

OFFICE OF THE LEGISLATIVE AUDITOR
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DEPARTMENT OF BUSINESS REGULATION
BOARD OF MILK CONTROL

REPORT ON THE NEED FOR MILK PRICE REGULATION IN MONTANA

December, 1976

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MONTANA LEGISLATIVE AUDIT COMMITTEE
AND OFFICE OF THE LEGISLATIVE AUDITOR

The Legislative Audit Committee is a joint, bipartisan standing committee of the Montana Legislature. The committee is composed of eight members (listed below) appointed by the Senate Committee on Committees with the approval of the Senate and the Speaker of the House.

The committee and the Office of the Legislative Auditor were established for the purpose expressed in Section 79-2301, R.C.M. 1947:

> "Because the legislative assembly is responsible for authorizing the expenditure of public moneys, designating the sources from which moneys may be collected, shaping the administration to perform the work of state government, and is held finally accountable for fiscal policy, the legislative assembly should also be responsible for the audit of fiscal accounts and records so that it may be assured that its directives have been faithfully carried out. It is the intent of this act that each agency of state government be audited for the purpose of furnishing the legislative assembly with factual information vital to the discharge of its legislative duties."

To accomplish the foregoing purpose, the Office of the Legislative Auditor is empowered by law to conduct audits of state agencies to ascertain, among other things, whether state agencies are:

> "... carrying out only those activities or programs authorized by the legislative assembly and is conducting them _efficiently_ _and_ _effectively_." (Emphasis supplied)

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December 10, 1976

The Legislative Audit Committee
of the Montana State Legislature:

Herein transmitted is our program/performance audit of the milk price regulation program administered by the Board of Milk Control and the Milk Control Division of the Department of Business Regulation.

The purpose and scope of this audit are explained in Chapter I (page 1) of the report, and in the summary which begins on page S-1.

This report contains major recommendations for changes in the milk price regulation program in Montana.

We wish to express our appreciation to the administrator and his staff and the numerous producers, processor/distributors and others in the milk industry for their cooperation and assistance.

Respectfully submitted,

Morris L. Brusett

Morris L. Brusett, C.P.A.
Legislative Auditor

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APPOINTIVE AND ADMINISTRATIVE OFFICIALS

BOARD OF MILK CONTROL

Genevieve Remillard, Chairman	January 1, 1977
Dr. Edward H. Ward	January 1, 1977
Kenneth Mortag	January 1, 1977
Rosemary Fiorentino	January 1, 1979
Curtis C. Cook	January 1, 1979

ADMINISTRATIVE OFFICIALS

Harold J. Pitts	Director, Department of Business Regulation
Kenneth M. Kelly	Administrator, Milk Control Division

OFFICE OF THE LEGISLATIVE AUDITOR

NEED FOR MILK PRICE REGULATION IN MONTANA

SUMMARY

This report is the result of our program audit of the Board of Milk Control and its administrative branch, the Milk Control Division of the state Department of Business Regulation. The audit is an outgrowth of our 1972 financial audit of the Department of Business Regulation. This audit is the first independent evaluation made of the milk price regulation program, one of Montana's oldest business regulatory programs.

CHAPTER I. INTRODUCTION

The report is organized into four chapters: Chapter I (page 1) discusses the organization of the report and the objectives and scope of the audit; Chapter II (page 4) presents background on the milk industry and state regulatory function in Montana and other states; Chapter III (page 32) presents an analysis of milk resale price controls in Montana and other states; and Chapter IV (page 91) presents a brief analysis of producer price controls, the operation of the producer price formula and the use of butterfat as the basis for the payment of milk prices in Montana.

The findings, conclusions and recommendations in the report were discussed with officials of the Department of Business Regulation and the five members of the Milk Control Board. The formal comments of these officials are included at the back of the report (page 108). The report was also circulated to numerous other groups and organizations which have an interest in milk price regulation. These groups and organizations include the U.S. Department of Agriculture and Federal

Trade Commission, Montana organizations such as the Montana Dairymen's Association, the American Dairymen's Association, Montana Food Distributor's Association, various dairy farmers around the state and all of the processor/distributors doing business in the state. While the comments of these organizations are not separately included in the report, their views have been included wherever appropriate throughout the report.

The objectives of the audit were twofold: (1) to evaluate the effect of and continued need for price controls over the milk industry in Montana, and (2) to determine whether alternatives to the present program of milk price controls exist which would better achieve the intent of the milk price control program set forth in Montana law (p. 2).

The scope of the audit included the economics, objectives, policies, methods and effects of milk price controls in Montana at the producer, wholesale and retail levels. The audit focused on the price regulatory activities of the Milk Control Division. It did not encompass the internal financial transactions of the Milk Control Division. This was done by our previous financial/compliance audit in 1972 and is being covered by a current CPA audit under contract with us (p. 3).

The audit also did not include the sanitary or health aspects of the milk industry. These are the responsibility of the state Department of Livestock rather than the Milk Control Division (p. 3).

CHAPTER II. BACKGROUND ON MILK PRICE CONTROL

Unlike most other commodities, fluid milk is unique--it is highly perishable and consequently cannot be stored for any length of time. This factor, combined with a drastic decline in demand, created surpluses which resulted in conditions the milk industry called "chaotic." The chaotic conditions--extremely low farm prices, price wars with price reductions passed to the producer, dumping of milk, marketing of unsanitary milk and a fluctuating and sometimes inadequate supply of milk--persisted through 1931 and 1932 (p. 4).

In 1933, Government intervention began, primarily on the premise that wholesome milk was a necessary item for human consumption. Accordingly, government action to assure an adequate supply of milk became a matter of the public interest (p. 4).

The government intervention to protect the public interest by assuring an adequate supply of milk was carried out at both the federal and state levels. The widespread belief and theory then, and now, was that government involvement through price control would protect producers by orderly marketing and stability, thereby assuring the production of an adequate supply of milk. The general theory was that open price competition over such a perishable product would result in excessively low prices which would force many producers out of business, thereby reducing the supply of drinking milk which in turn would be followed by excessive price increases to the consumer. The government began to set prices not only at the producer level, but also at the resale (wholesale and retail) level (p. 4).

As a general rule, the theory has not been tested since a real shortage of milk has not recently occurred. Nevertheless this theory, and industry fear of cutthroat competition, whether real or imagined, remain as the major justifications for government involvement in the milk marketing processes (p. 5).

In 1933 the Congress passed the Agricultural Adjustment Act which provided for marketing agreements which fixed producer, wholesale, store, and home-delivered prices for milk products in interstate or foreign commerce. Seven months after passage of the federal legislation, price regulation was abandoned by the federal government (p. 5). In lieu of total price controls, the federal government turned its attention to Federal Milk Market Orders which established minimum producer prices only (p. 6).

Currently the federal government controls producer prices of drinking milk through 55 Federal Milk Market Orders--accounting for 80 percent of the nation's fluid milk sales in 1975. In some cases, the area covered by a Federal Milk Market Order is part of a state while in other cases, it may encompass several states (p. 6).

During the 1930's, the states were faced with various options to seek relief from the chaotic conditions in the milk industry. As previously mentioned, the milk industry in some areas of the nation sought federal controls. In other instances, the milk industry sought state controls over producer and resale prices. The milk industry in Montana sought to control the producer and resale prices through state legislation rather than federal controls. In many cases, the state laws were emergency and apparently temporary measures intended to overcome the chaotic conditions which existed. This was true in Montana's case, where the original 1935 legislation expressly declared that a public emergency existed and stipulated that the period of public emergency would exist until such time that the legislature declared it terminated (p. 9).

Since the 1930's the number of states controlling resale milk prices decreased from 26 to 14. Actually, the number of states exercising state resale controls during that period fluctuated as some states adopted or eliminated various forms of resale price controls. In some states, such as Montana, state milk price controls are the only form of price controls while in other states such as North Dakota there is a combination of federal and state price controls. There are four general levels of price controls currently existing among the states (p. 10).

The extent and level of controls over milk prices varies among the states. Some states have price controls at all levels (such as Montana) while other states have price controls only at the producer level or resale level. Only one state has no price controls whatsoever--Alaska (p. 11).

The states fixing resale prices in the milk industry, including Montana, are clearly in the minority. On the other hand, 98 percent of the states (49 states) have producer price regulation of some form. Considering this and the fact that 80 percent of the nation's drinking milk is regulated under federal producer controls, it becomes obvious that virtually all drinking milk is subject to either state or federal producer price controls. These statistics lead to the conclusion that: (1) most jurisdictions accept the premise that milk prices need to be stabilized by government intervention at the farm level to assure an adequate supply of milk; and (2) price regulation at the resale level is not universally accepted as being necessary to assure an adequate supply of milk (p. 11).

Montana is one of 26 states which chose a system of state milk price controls. The Montana Legislature first authorized control of

Montana's milk industry in March 1935. The law was enacted to alleviate the same conditions as were being experienced throughout the nation, i.e., price wars, dumping of milk, marketing of unsanitary milk and a fluctuating and sometimes inadequate supply of milk (p. 12).

The language of the 1935 act indicates that the measures were both necessary and apparently temporary to meet the emergency conditions which existed at that time (p. 12).

Montana's milk control laws are among the most comprehensive and stringent in the nation. The current milk control laws require the board to fix the minimum milk prices not only at the producer level, but also at every level of resale. This means that the state fixes the price of milk paid to dairy farmers, dairy processors, and distributor-jobbers, as well as the price of milk in the grocery dairy case (p. 15).

The board further regulates the milk industry through laws which prohibit certain unfair trade practices. Regulations have been established specifically prohibiting secret rebates, refunds, unearned discounts, giving milk, cream, dairy products, or services for the purpose of securing customers, giving of special prices, or providing coolers and dispensers for milk. In essence these practices indirectly dilute the minimum prices established by the board for milk. Consequently, the board is interested in eliminating these practices where they are found to exist (p. 16).

The milk industry can be categorized into two major segments--the producer segment and the resale or distribution segment. The producer segment is dairy farmers, while the remainder of the milk industry is involved in the homogenizing, pasteurizing, manufacturing, packaging and marketing of the milk and milk products (p. 18).

Milk processing and distribution operations steadily became more efficient after the thirties. Improvements in transportation and capability for longer storage broke natural boundaries between markets and encouraged competition. This resulted in a decrease in the number of processors and an increase in the average size of processing plants. This trend has continued to the present, not only in Montana, but nationally, and not only in the milk industry but also in the agricultural sector in general (p. 27).

There were 23 processors in Montana in 1976. Nine of these processors were small producer-distributor farmers who process their own milk production. Excluding these nine, there were 14 processors purchasing and processing fluid milk. Comparing these plants to the trends in plant size, Montana is similar to the nation (p. 21).

Just as the production and processing sectors of the milk industry have changed over the years, so has the distribution sector changed (p. 24). Costs differ with the various types of distribution. There is no incentive for retailers to use more efficient methods of distribution in Montana since all milk is priced the same at the wholesale and retail levels (p. 27). The present pricing system in Montana does not encourage the use of more efficient forms of distribution. While the national trend moves from high-cost toward low-cost distribution methods, Montana continues to use high-cost methods (p. 27).

Milk is produced under two sanitary standards. Grade A, the most stringent, is milk produced under sanitary conditions making it fit for human consumption in its fluid form. Milk produced under grade B standards can be used for manufactured products only, i.e., ice cream, cheese, butter, and cottage cheese (p. 27).

Trends in fluid milk consumption are major factors in determining milk control policies. The total volume of milk processed by milk processing companies increased steadily until it peaked in the 1950's (p. 28). While many factors affect the demand for milk and milk products, authorities expect that milk consumption will remain fairly stable or possibly increase slightly over the next decade (p. 29).

CHAPTER III. RESALE PRICE CONTROLS

The early legislation in Montana not only recognized the need for stability in the milk industry, but also recognized the need for directness, efficiency and economy in the marketing of milk from producer to consumer (p. 35). There are three potential measures of distribution efficiency: comparison of distributor unit costs, comparison of retail milk prices, or a comparison of distributor gross margins (p. 35). The first two cannot be used in Montana (p. 36). The latter distributor gross margin or DGM can be used to assess the marketing systems in Montana (p. 36).

Montana had the highest DGM in almost all instances of recent comparisons to a number of other states. The DGM in Montana was exceeded only in two instances, by South Dakota, a state which is similar to Montana in terms of milk price regulation: that is, government price controls at all levels. In fact, as a general rule, the higher DGM's were all in states with resale controls. In contrast, the prevailing lowest DGM was found in the adjacent noncontrol states (p. 38).

In free market areas, milk retailers compete for consumer dollars with a wide variety of services and prices. Milk in adjacent states is being sold in a variety of ways and prices in the uncontrolled markets (p. 41).

Our survey of prices in surrounding states was followed by a survey made by the board which generally confirmed what we had found earlier. The important point depicted by the surveys of prices in surrounding states is the wide range of prices in the adjacent markets compared to Montana. In the adjacent areas, customers pay more for the convenience of home delivery and for convenience buying which occurs at the convenience-type stores such as the chain convenience marts and the small neighborhood grocery stores. In this regard, most customers in the adjacent market areas, and in Montana, do their primary grocery shopping in the supermarkets or large grocery stores and patronize the convenience stores on an incidental and last-minute or convenience basis (p. 41).

Innovation in milk distribution systems in Montana has been absent or slow and the philosophy has seemingly been to protect the distributors whether efficient or inefficient. The only exception the board has permitted to the uniform pricing has been the allowance of "on-the-farm sales" of a producer-distributor and this came about in the early sixties only after a state district court ordered the board to conduct an administrative hearing on the price structure in that particular marketing area. The end result was that the board allowed on-the-farm sales (p. 42).

It appears that the minimum retail price established by Montana is above the natural or equilibrium price which would be set by the competitive market forces of supply and demand (p. 46). There is strong evidence that milk in Montana is overpriced. This conclusion is evidenced by the fact that (1) Montana's DGM's are generally higher than surrounding states (p. 38), (2) milk in Montana is not being sold above the minimum price fixed by the state (p. 46), (3) milk is delivered to the consumer's doorstep for the same price as it is available in the dairy case (p. 41), (4) milk is sold to federal installations, state institutions and schools at a price less, and substantially less in some cases, than the fixed price (p. 49), (5) firms are evidently willing to competitively bid for opportunities to sell milk at a price which is less than the fixed price (p. 50), and, finally, (6) some firms are willing and in some instances have sought authority to sell milk for less than the price fixed by the state (p. 52).

There is also strong evidence that the demand for milk in Montana corresponds closely to the price, i.e., consumers will decrease their purchases of drinking milk if the price is excessive and in fact have done so in recent years (p. 57).

These factors have had an adverse effect on both consumers and farmers (p. 60).

The independent processors and cooperatives in Montana generally favor continuation of resale price control (p. 61). The comments made by the processors regarding the potential elimination of resale price controls can be divided into several categories (p. 63).

While virtually all of the information and data available indicates that elimination of resale price controls will benefit society by way of more efficient processing and lower prices, the fact remains that the processing segment of the milk industry in Montana fears the open competition which would result if resale price controls were eliminated. Virtually all of the processors with whom we discussed the issue of elimination of price controls expressed two major points. First of all, they generally expressed the view that they could compete with any other firm provided the competition was fair. Secondly, they all expressed a fear of predatory trade practices by one of the national dairy firms which currently sells 37 percent of the milk in Montana (p. 78).

Although the fear of open competition is genuine, there is substantial evidence, as previously mentioned elsewhere in the report, to indicate that the fear may be unfounded (p. 79). It is evident that the extensive price controls which Montana has had for over 40 years have not in themselves been effective in curtailing the circumstances which the domestic processing industry apparently fears (p. 79). The industry has changed in spite of the controls: the small plants have been replaced by larger operations as previously mentioned and there have been numerous instances and allegations of illegal and unfair trade practices among the various elements of the milk industry in Montana (p. 79).

Unfair trade practices in the dairy industry are not limited to Montana. They appear to be a fact of life in the dairy industry that such practices occur with or without resale price regulation (p. 80).

Some states have offset the fear of a catastrophe in the milk industry through measures prohibiting unfair trade practices such as sales below cost and by giving the state milk control agency the prerogative to act in extreme cases (p. 81). Although the milk control laws are silent with respect to emergency or standby powers, there are state laws which currently provide the board and similar agencies with the authority to act swiftly in the public interest (p. 82).

The Montana milk laws currently provide for the licensure of producers, distributors and jobbers. There is no requirement nor statutory authority under the milk laws to license retailers, i.e., those firms engaged in the retail segment of the milk industry such as the supermarkets and grocery stores (p. 83).

Some other states, some of which control resale prices and some who do not, require that retailers of milk be licensed (p. 83). Those with whom we discussed the possibility of retail licenses generally agreed that enforcement of the state milk control laws could be more effective if the retail segment of the industry were licensed (p. 84). The Montana law should be amended to provide for the licensing of those firms which sell milk at retail (p. 85).

In conclusion, the state legislature has clearly established the fact that the milk price control laws in Montana are primarily intended to insure an adequate supply of milk for the people in Montana and to make the distribution of milk between the producer and consumer as direct, efficient and economical as possible. To accomplish these objectives and overcome chaotic conditions which existed in the 1930's, the law provided for a complex system of milk price controls at the producer, wholesale and retail levels. While this system of milk price controls appears to have been faithfully carried out by the board and has unquestionably accomplished the objectives of the law over the years, the necessity of its continuance in certain areas is questionable (p. 85).

There is evidence to indicate that the conditions which prompted the enactment of the milk control laws in the 1930's have changed to the extent that certain provisions of the milk price control law are no longer warranted (p. 86).

There is also substantial evidence to indicate that milk price controls at the resale level are no longer in the public interest and that such controls at the resale level may have an adverse effect upon both consumers and dairy farmers--the very ones the law is supposed to benefit (p. 86).

Although continuation of resale price controls appears to be no longer warranted, sales of milk and milk products below cost should be explicitly prohibited. In addition, the board should have some degree of standby powers to act in extreme situations. These powers should be limited to situations in which temporary emergency action is necessary to avert or correct chaotic conditions which might arise at various locations in Montana.

RECOMMENDATION (p. 89)

We recommend that the board and department:

1. *Support legislation to:*
   - *(a) repeal the mandatory provisions of the current law which require the setting of resale prices for milk.*
   - *(b) prohibit sales of milk and milk products below cost.*
   - *(c) obtain standby powers to temporarily set resale prices in extreme situations.*
   - *(d) provide for the licensure of firms which sell milk at retail.*
2. *Discontinue the setting of resale prices in an orderly fashion if appropriate legislation is enacted.*
3. *Conduct an aggressive and routine program of investigation and enforcement against unfair competitive practices in the milk industry.*

The department generally agrees with the recommendations with certain reservations (p. 109) as do two of the five board members (pp. 113, 119). The other three board members agree with only the recommendations pertaining to retail licensure and enforcement of unfair trade practices but disagree with the remaining recommendations (p. 115). Their disagreement is based primarily upon their belief that the present system of milk price controls is working satisfactorily. They prefer to leave the system as it now is.

* * *

CHAPTER IV. PRODUCER PRICES

In addition to the resale price of milk the state also sets the minimum price of milk at the producer level, i.e., the price paid to the dairy farmer for the milk his dairy herd produces. This chapter discusses various aspects of the process used by the state to set the price of milk at the producer level. Montana law directs the board to fix minimum producer prices by means of a flexible formula that brings about such automatic price adjustments as are justified on the basis of changes in production costs and milk supply. This is accomplished by means of a formula which is separate and distinct from the formula used to set resale prices (p. 91).

Prior to conversion to the flexible formula the Montana board used actual dairy farm costs of production to set prices. The formula approach was implemented in lieu of the cost studies on May 1, 1972 and has been used since (p. 91).

The content of the present formula for setting minimum producer prices differs from that originally implemented (p. 92). The formula currently used to set producer prices is based on the following indices/factors (p. 93):

1. Percent Unemployment - U.S.
2. Percent Unemployment - Montana
3. Weekly Wages - Total Private
   (Revised and Seasonally adjusted)

4. Prices Received by Farmers - Montana
5. Mixed Dairy Feed Price
6. Alfalfa Hay Price
7. Prices Paid by Farmers - U.S.

The board relies entirely upon the formula to set the prices, the exceptions being those instances where producers request a change in the formula which subsequently results in a price increase. Whether such price increases are too much, too little or just right is unknown and is a matter of conjecture. The producers and processors with whom we discussed the formula process generally agreed that the formula is a far more responsive approach to price setting than the prior method of hearings and occasional cost studies. At the same time they almost universally expressed concern over the fact that the board does not have actual data on the cost of producing and processing milk in Montana (p. 95). The board currently does not use a systematic means of determining whether the milk prices set by the formula and paid to producers are appropriate in terms of actual production costs or whether changes in the milk price, brought about by the producer price formula, are warranted on the basis of actual production costs. The board also had no accurate means of determining whether or not the price changes allowed by the board actually accomplish the objectives of the price change, that is, to compensate the producer for higher costs (p. 95).

Inasmuch as the board is responsible for the formula and the setting of the price of milk at the producer level, the board should have some systematic means of feedback on the impact of its price setting policies. The board needs a system which furnishes routine and timely data on the actual cost of milk production and the impact of component price changes on production costs (p. 96).

The board should explore the feasibility of developing a system of actual production cost feedback such as the system being tested by the Cooperative Extension Service at Montana State University (p. 97).

A feedback system such as the foregoing would provide the board with factual information about the adequacy of the price formula, need for price changes, and the impact of price changes made by the formula.

RECOMMENDATION

We recommend that the board consult with the Cooperative Extension Service at Montana State University to explore and, if appropriate, to develop and implement an information system for use in conjunction with the formula price process which systematically compiles data on the actual cost of producing milk in Montana.

The department generally agrees with the recommendation (p. 109) as do three of the five board members (p. 116). Two board members do not agree with the recommendation (pp. 114, 119). The two board members disagree because they do not believe accurate cost data can be obtained and used by the board. As pointed out in the text, cost of milk production data is currently being obtained in North Carolina and California and possibly other states under the auspices of the respective milk control agencies. This data is being used to assess the adequacy of milk producer prices. There is no question that accurate uniform data can be compiled should the board seek it.

* * *

During the course of discussions with producers and processors it became obvious that the issue of measuring butterfat content may be a problem in the industry (p. 101).

Several problems appear to exist: some of the producers are not confident that tests are correct (p. 102); there is evidence that the sampling procedures used to obtain milk for the butterfat tests are inadequate and subject to question (p. 102); there are various methods in use for conducting the tests of milk for butterfat (p. 102); finally, the responsibility for butterfat testing is divided between the Department of Livestock and the board. At the present time no one independently tests or verifies the butterfat testing procedures or results on a routine basis (p. 102).

In addition to the foregoing, a question exists as to the appropriateness of a price and payment system which results in an incentive for the production of milk with a high butterfat content (p. 102). This is questionable because a trend exists to greater consumption of milk with a lower butterfat content; the average butterfat content of fluid milk consumed has decreased steadily from 3.4 percent in 1967 to 2.9 percent in 1976 and there has been an increase in the value of butterfat for Class II and Class III uses.

Because of the foregoing, the board should consider the propriety of basing milk prices and payments on a system which induces the production of milk with a high butterfat content. The board should sponsor or undertake a study to determine whether the current system of butterfat sampling, testing, and milk pricing is appropriate, make administrative changes in conjunction with the Department of Livestock where possible, and propose legislative changes where necessary.

RECOMMENDATION

We recommend that the board undertake a study to examine the current procedures used by the milk industry and the board to sample, test and price milk on the basis of butterfat content.

The department agrees with the recommendation (p. 109), as do two of the five board members (pp. 114, 119). Three of the board members do not agree with the recommendation (p. 116). Their disagreement stems from their belief that the present system is satisfactory.

* * *

Chapter I

INTRODUCTION

This is the report of our program audit of the Board of Milk Control and its administrative branch, the Milk Control Division of the State Department of Business Regulation. The audit is an outgrowth of the 1972 financial audit of the Department of Business Regulation. This audit evaluates the performance of one of Montana's oldest business regulatory programs.

ORGANIZATION OF THE REPORT

This report is presented in four chapters.

Chapter I presents an introduction to the report and summarizes the objectives, scope, and special problems of the audit.

Chapter II presents a background of the milk industry and the state regulatory function. Included in the background are history, trends, and descriptions which will familiarize you with the current situation in the dairy industry.

Chapter III presents an analysis of milk resale price controls--the effect they have had on supply, technology, efficiency, and prices in Montana and other states. Economic theory is used to explain relationships, events, and draw conclusions with respect to controls and the industry. Audit evidence supports the economic analysis and reinforces the conclusions. These conclusions lead to the recommendations located at the end of the chapter.

Chapter IV presents a brief analysis of producer price controls and the operation of the formula with respect to producers. Conclusions based upon this analysis and recommendations follow the analysis. Problems associated with the measurement and payment on the basis of butterfat content are also discussed in the chapter and a recommendation is made to resolve the problems.

Finally, the comments of the individual members of the Board of Milk Control and the Department of Business Regulation with respect to the report are included separately at the back of the report. Although their formal comments are not included separately in the report, we also discussed our findings, conclusions and recommendations with numerous other groups and organizations which have an interest in milk price regulation. At the conclusion of our field work, we circulated a preliminary draft of the audit report to 19 groups and organizations for comment. These groups and organizations included federal agencies such as the U.S. Department of Agriculture and the Federal Trade Commission, Montana organizations such as the Montana Dairymen's Association and the Montana Food Distributors' Association, and various producers as well as all of the processor/distributors doing business in the state. While the comments of these organizations are not separately included in the report, their views have been included and incorporated throughout the report.

OBJECTIVES OF THE AUDIT

The objectives of the audit were:

1. To evaluate the effect of and continued need for price controls over the milk industry in Montana.
2. To determine whether alternatives to the present program of milk price controls exist which would better achieve the intent of the milk price control program set forth in Montana law.

SCOPE OF THE AUDIT

The audit focused upon the price regulatory activities of the Milk Control Division of the State Department of Business Regulation. The audit examined the economics, objectives, policies, methods and effects of milk price control policies in Montana at the producer, wholesale and retail levels. The audit did not encompass the internal financial transactions of the Milk Control Division because that was done in conjunction with the 1972 financial/compliance audit of the Department of Business Regulation. Another financial/compliance audit as of June 30, 1976, is being completed by a CPA firm under contract with the Office of the Legislative Auditor. In addition, the audit did not include an examination of the sanitary or health aspects of the milk industry. These aspects are the responsibility of the Department of Livestock.

Chapter II

BACKGROUND ON MILK PRICE CONTROL

Government intervention in the milk marketing processes has been a fact since the Great Depression. Prior to that time, in the decade of the twenties, the milk industry enjoyed a generally favorable economic climate with virtually no government involvement in the market processes. The conditions changed during the 1930's with the Great Depression. Consumer purchasing power collapsed and the demand for milk and milk products, as well as other commodities, declined substantially, resulting in large surpluses and smaller markets.

Unlike most other commodities, fluid milk is unique--it is highly perishable and consequently cannot be stored for any length of time. This factor, combined with a drastic decline in demand, created surpluses which resulted in conditions the milk industry called "chaotic." The chaotic conditions--extremely low farm prices, price wars with price reductions passed to the producer, dumping of milk, marketing of unsanitary milk and a fluctuating and sometimes inadequate supply of milk--persisted through 1931 and 1932.

In 1933, government intervention began, primarily on the premise that wholesome milk was a necessary item for human consumption. Accordingly, government action to assure an adequate supply of milk became a matter of the public interest.

The government actions to protect the public interest by assuring an adequate supply of milk were carried out at both the federal and state levels. The widespread belief and theory then, and now, was that government involvement through price control would protect producers by orderly marketing and stability, thereby assuring the production of an adequate supply of milk. The general theory was that open price competition over such a perishable product would result in excessively low prices which would force many producers out of business, thereby reducing the supply of drinking milk which in turn would be followed by excessive price increases to the consumer. The government began to set prices not only at the producer level, but also at the resale level. In this respect, resale refers to the wholesale and retail levels including processors, distributor-jobbers and retailers.

As a general rule, the theory has not been tested since a real shortage of milk has not recently occurred. Nevertheless this theory, and industry fear of cutthroat competition, whether real or imagined, remain as the major justifications for government involvement in the milk marketing processes.

MILK CONTROL HISTORY

Technological problems in the milk industry existed long before the Great Depression and the state and federal regulations which followed. Federal and state intervention, through price and trade regulations, as well as major changes in the industry structure and improved technology and distribution methods combined to alleviate the problems of the thirties. The history and nature of these changes are discussed in the remainder of this chapter.

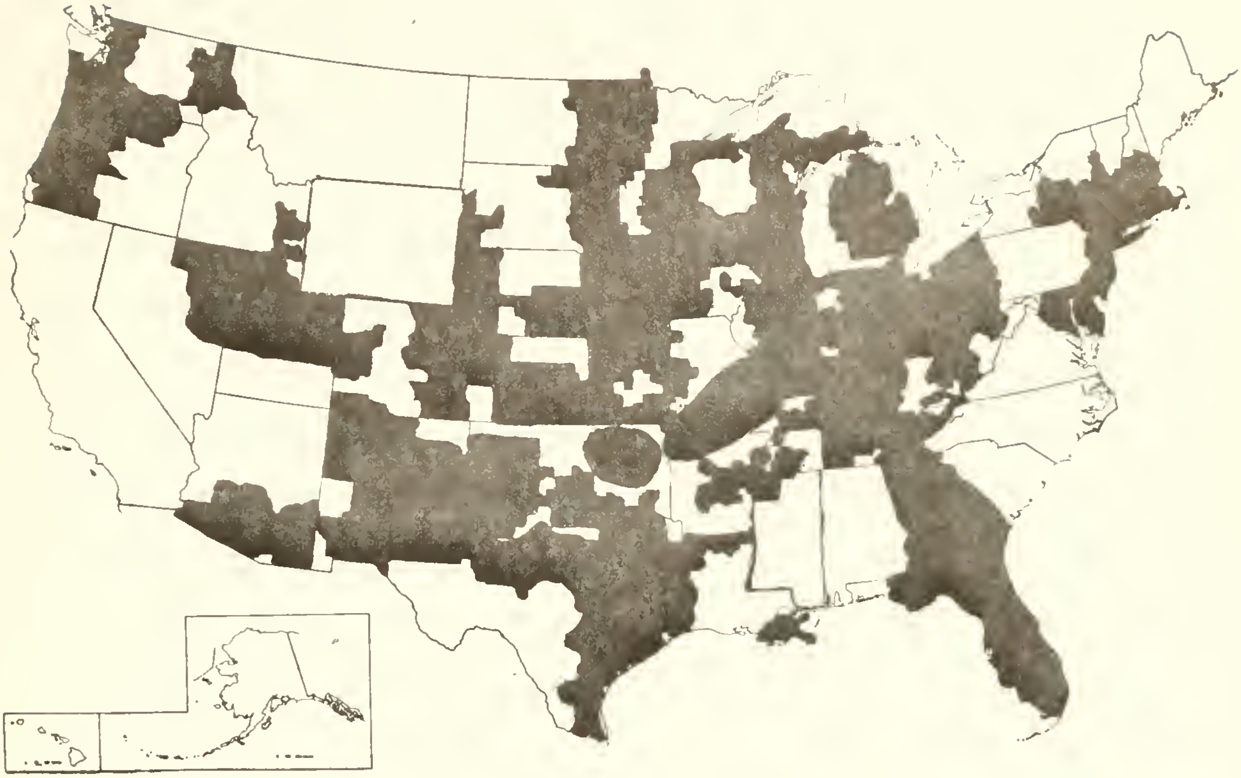
Federal Control

In 1933 the Congress passed the Agricultural Adjustment Act which provided for marketing agreements which fixed producer, wholesale, store, and home-delivered prices for milk products in interstate or foreign commerce. Seven months after passage of the federal legislation, price regulation was abandoned by the federal government. According to historical records, federal controls were abandoned because of their inability to control unnecessarily wide distributor margins which encouraged chiseling and secret rebates and discounts, under-the-counter deals between producers and processors, and rampant violation of the fixed prices, particularly in markets that did not overlap state boundaries. In lieu of total price controls, the federal government turned its attention to federal orders which established minimum producer prices only. These federal orders, officially referred to as Federal Milk Market Orders, were also based upon the federal Agricultural Adjustment Act of 1933, and were instituted in 1937 by the U.S. Department of Agriculture. Federal Milk Market Orders are implemented at the request of producers in a given milk production area.

Federal Milk Market Orders differ from the earlier federal effort in several respects, but primarily from the standpoint that they focus only upon producer prices rather than all prices, i.e., producer, processor, distributor-jobber and retailer prices.

Currently the federal government controls producer prices of drinking milk through 55 Federal Milk Market Orders--accounting for 80 percent of the nation's fluid milk sales in 1975. In some cases, the area covered by a Federal Milk Market Order is part of a state while in other cases, it may encompass several states. Illustration 2.1 shows the Federal Milk Market System as of January 1, 1976.

Illustration 2.1
FEDERAL MILK MARKET ORDER AREAS
January 1, 1976



Source: U.S. Department of Agriculture map of Federal Milk Market Orders, January 1, 1976

Milk prices under Federal Milk Market Orders throughout the nation are based in large part upon the prices paid for manufacturing-grade milk (i.e., milk used for manufacturing purposes rather than drinking purposes) in the Minnesota-Wisconsin area (referred to as the Minnesota-Wisconsin price series). The price of manufacturing-grade milk rather than the price of drinking-grade milk is used as a base because it is bought and sold under relatively free market conditions, i.e., there is virtually no direct government control of the price except as it is influenced by the dairy price support program. The Minnesota-Wisconsin area is used because that area is, in effect, the heart of the nation's dairyland.

The base prices established by the Minnesota-Wisconsin series prices are modified under each Federal Milk Market Order by the addition of appropriate amounts to cover the additional costs in each part of the nation associated with the production and transportation of drinking-grade milk.

While the manufacturing-grade price is the basic starting point for establishing minimum producer prices under Federal Milk Market Orders, another farm stabilization program authorized by the federal Agricultural Act of 1949 indirectly influences the price of milk under Federal Milk Market Orders. This act provides for a dairy-price support parity program in which the U.S. Department of Agriculture seeks to stabilize and protect farm income by establishing prices at which the Commodity Credit Corporation will buy various manufactured dairy commodities including non-fat dry milk, butter and cheddar cheese. Purchases or guarantees of purchases of these commodities by the Commodity Credit Corporation stabilizes the demand for these products and consequently affects the price for manufacturing-grade milk. Any upward adjustment of the unregulated price of manufacturing-grade milk automatically increases the price of drinking milk under Federal Milk Market Orders.

Although the dairy-price support program and the Federal Milk Market Order program are often considered as two independent programs, there are important interrelationships between them. One recent U.S. Department of Agriculture report expressed the view that in some respects, the dairy-price support program has had more far-reaching effects on the price of dairy products than has the Federal Milk Market Order program.[1] The absolute effect of these federal programs on drinking milk prices in Montana is unclear. Prior to May 6, 1976, the effect was nonexistent or negligible primarily because no Federal Milk Market Orders encompassed Montana. On that date, a state Board of Milk Control order became effective which ties the minimum producer price for drinking milk in Montana at either an adjusted price based on the Minnesota-Wisconsin price series or Montana's producer formula price--whichever is lower. Consequently, fluctuating Minnesota-Wisconsin price series could now have an effect on Montana milk prices. However, Montana's producer formula will continue to set the minimum price for milk, except when Minnesota-Wisconsin price series fluctuate downward dramatically, in which case the Montana minimum price will be adjusted downward.

State Controls

During the 1930's, the states were faced with various options to seek relief from the chaotic conditions in the milk industry. As previously mentioned, the milk industry in some areas of the nation sought federal controls. In other instances, the milk industry sought state controls over producer and resale prices. The milk industry in Montana sought to control the producer and resale prices through state legislation rather than federal controls. In many cases, the state laws were emergency and apparently temporary measures intended to overcome the chaotic conditions which existed. This was true in Montana's case, where the original 1935 legislation (Chapter 189, Laws of 1935) expressly declared that a public emergency existed and stipulated that the period of public emergency would exist until such time that the legislature declared it terminated.

In five states, the state supreme courts declared the milk price control laws unconstitutional in less than 18 months after their enactment. The constitutionality of Montana's milk price control law was challenged in 1962 and upheld as being constitutional by the state supreme court in Milk Control Board v. Rehberg, 141 Mont. 149 (1962).

Since the 1930's, the number of states controlling resale milk prices decreased from 26 to 14. Actually, the number of states exercising state resale controls during that period fluctuated as some states adopted or eliminated various forms of resale price controls. In some states, such as Montana, state milk price controls are the only form of price controls while in other states such as North Dakota, there is a combination of federal and state price controls. There are four general levels of price controls currently existing among the states. These general levels are summarized in the following illustration and depicted on a state by state basis at Appendix A on page 106.

Illustration 2.2

LEVELS OF MILK PRICE CONTROLS IN THE 50 STATES

Level of Control	States Number	States Percent
Producer		
Federal	31	62
State	9	18
Federal/State Combination	9	18
None	1	2
Total	50	100
Wholesale		
State	13	26
None	37	74
Total	50	100
Retail		
State	11	22
None	39	78
Total	50	100
Prohibits Sales Below Cost		
State	25	50
None	25	50
Total	50	100

Source: Compiled by Office of the Legislative Auditor.

The extent and level of controls over milk prices varies among the states. Some states have price controls at all levels (such as Montana) while other states have price controls only at the producer level or resale level. Only one state has no price controls whatsoever--Alaska. As shown in the preceding illustration, only 13 states (including Montana) have milk price controls at the wholesale level, and only eleven states (also including Montana) control the retail price of milk. The status of price control in the milk industry is further illustrated by Appendix A. Analysis of Appendix A shows that 72 percent (36 states) do not fix resale milk prices and only 28 percent (14 states) do. Of the 36 states that do not fix resale milk prices, 12 states control resale prices only to the extent that they prohibit "sales below cost."

The states fixing resale prices in the milk industry, including Montana, are clearly in the minority. On the other hand, the illustration discloses that 98 percent of the states (49 states) have producer price regulation of some form. Considering this and the fact that 80 percent of the nation's drinking milk is regulated under federal producer controls, it becomes obvious that virtually all drinking milk is subject to either state or federal producer price controls. These statistics lead to the conclusion that: (1) most jurisdictions accept the premise that milk prices need to be stabilized by government intervention at the farm level to assure an adequate supply of milk; and (2) that price regulation at the resale level is not universally accepted as being necessary to assure an adequate supply of milk.

Montana Controls

Montana is one of 26 states which chose a system of state milk price controls. The Montana Legislature first authorized control of

Montana's milk industry in March, 1935. The law, (Chapter 189, Laws of 1935), was enacted to alleviate the same conditions as were being experienced throughout the nation, i.e., price wars, dumping of milk, marketing of unsanitary milk and a fluctuating and sometimes inadequate supply of milk.

The language of the 1935 act indicates that the measures were both necessary and apparently temporary to meet the emergency conditions which existed at that time. In this regard, the 1935 legislation expressly:

1. declared that a "public emergency" existed.
2. stated that the purpose of the law was

   > "to protect and promote public welfare and
   > to eliminate unfair and demoralizing trade
   > practices."

3. created the Milk Control Board (hereinafter referred to as the board) and gave the board clear authority to
   a. supervise, regulate and control the distribution and sale of milk within the state,
   b. fix minimum prices to be paid to milk producers, and
   c. fix minimum wholesale and retail (resale) milk prices at a level no higher than necessary to cover the costs (plus reasonable return on investment) of efficient and economical milk dealers.
4. stated that the period of public emergency would continue until such time as the legislature declared the emergency to be terminated and repealed the act.

The 1935 milk control law was essentially reenacted in 1939 through legislation which created a permanent milk control board and system of milk price controls. The provisions of the 1939 legislation basically restated the prior 1935 law, but also amplified the power and authority of the milk control board and defined the public interest basis for the law. In this regard, the 1939 legislation (Chapter 204, Laws of 1939) expressly stipulated among other things that:

1. milk is a necessary article of food for human consumption;
2. the production and preservation of an adequate supply of milk is vital to the public health and welfare;
3. it is the policy of the state to foster production, eliminate speculation and waste, and make the distribution of milk between the producer and consumer as direct, efficient and economical as possible.

The statutory composition of the board has also changed over the years. Initially, in 1935, the board was an independent state agency composed of three members representing, by law, the former Livestock Sanitary Board, the state Department of Agriculture and the general public. In 1939 the membership of the board was modified and expanded by law to five members including a representative of the former Livestock Sanitary Board, the producers, producer-distributors, distributors and a consumer. In 1959 the composition of the board was completely changed.

The 1959 legislation (Chapter 192, Laws of 1959) further strengthened the authority and power of the board. Most important of all, the 1959 legislation specified that none of the board members could be "... connected in any way with the production, processing, distribution or wholesale or retail sale of milk or dairy products in any manner whatsoever." Consequently, rather than being strictly milk-industry oriented, the board is composed of an attorney, a banker, a court officer, a professor and a rancher.

As previously mentioned, the constitutionality of the Montana milk price control laws was challenged in 1962. The state supreme court decision in Milk Control Board v. Rehberg, supra, affirmed the constitutionality of the Montana law and specifically cited the public interest aspect of the law by recognizing the statutory consumer or general public composition of the board leaving the "... control in the hands of the public, the ones for whose benefit the Act was enacted."

As a result of the Executive Reorganization Act of 1971 (Section 82A-406, R.C.M. 1947) the board is a quasi-judicial board within the state Department of Business Regulation. In this regard, the board carries out its activities through the Milk Control Division (hereafter referred to as the division) of the department.

The division administers policies set forth by the board. The division has an administrator who is responsible for overall enforcement and supervision of the staff of seven, including three auditors, who review processing plant records to verify the amount producers receive for their milk, and an investigator-auditor for the investigation of violations of milk control laws and regulations.

The funding for the Milk Control Division comes from an assessment on both the producer and the processor of 4¢ per hundredweight (cwt) for milk sold. These funds are administered as an earmarked revenue fund. Producers-distributors and out-of-state distributors selling in Montana pay 8¢/cwt as they skip the usual transactions from producer to processor. Prior to July 1, 1975 the assessment was 2.5¢ per cwt. Illustration 2.3 shows general budgetary information about the Milk Control Division over the past 10 years.

Illustration 2.3

MILK CONTROL DIVISION BUDGETARY DATA

FY 1966 - FY 1975

Fiscal Year	Revenue	Expenditures	Average Employees
1966	$ 89,080	$ 84,540	8.00
1967	91,218	94,343	9.00
1968	101,942	98,050	7.82
1969	112,019	98,368	9.25
1970	105,422	101,090	6.60
1971	107,264	115,965	7.00
1972	118,083	104,632	6.17
1973	124,799	106,661	6.60
1974	104,878	119,823	7.52
1975	103,669	125,930	8.00

Source: Executive Budgets and Annual Reports to the Governor, 1966-75

Montana's milk control laws are among the most comprehensive and stringent in the nation. The current milk control laws require the board to fix the minimum milk prices not only at the producer level, but also at every level of resale. This means that the state fixes the price of milk paid to dairy farmers, dairy processors, and distributor-jobbers, as well as the price of milk in the grocery dairy case.

Historically, minimum milk prices were set on the basis of extensive data collected by examination of industry cost-of-production records and data presented at hearings conducted by the board. However, 1971 legislation changed the pricing method by directing that the various minimum prices be established by means of flexible formulas. The formulas are intended to bring about automatic changes in milk prices as are justified on the basis of changes in cost of production, processing, distribution, and retailing, and the willingness of consumers to pay the price.

The initial formula instituted by the board in 1972 included 18 indices intended to represent milk producing cost factors, milk processing cost factors, the abilities of consumers to purchase, and factors relating to alternative opportunities of employment and business open to the milk producer. That formula was subsequently revised in 1973 and divided into two formulas (one for the producer level, and one for the wholesaler, distributor-jobber and retailer levels). The formulas are checked monthly by the division for possible need of price adjustment whereas the cost-of-production method required completion of a time-consuming cost study when a price adjustment was requested by the industry. The significant advantage of using a formula as compared to the previous cost-of-production method is the formulas' increased responsiveness to cost changes. This responsiveness is shown in illustration 2.4 which illustrates the frequency and amount of price changes caused by the formula.

The board further regulates the milk industry through laws which prohibit certain unfair trade practices. Based on these laws which are discussed elsewhere in the report, regulations have been established specifically prohibiting secret rebates, refunds, unearned discounts, giving milk, cream, dairy products, or services for the purpose of securing customers, giving of special prices, or providing coolers and dispensers for milk. In essence, these practices indirectly dilute the minimum prices established by the board for milk. Consequently, the board is interested in eliminating these practices where they are found to exist.

Illustration 2.4
PRODUCER AND RETAIL PRICE CHANGES IN MONTANA - 1965-1976

	Producer		Processor-Distributor	
Date Price Changed	Months Since Last Change	Minimum Producer Price Per CWT	Months Since Last Change	Minimum Retail Half Gallon Price
April 1, 1965	--	$5.50	--	$0.51
September 15, 1966	17.5 months	5.85	17.5 months	.54
August 1, 1968	22.5 months	6.30	22.5 months	.59
April 1, 1970	21.0 months	6.50	21.0 months	.61
May 1, 1972 (Formula)	25.0 months	6.78	25.0 months	.63
September 1, 1972	4.0 months	7.06	4.0 months	.65
December 1, 1972	3.0 months	7.20	3.0 months	.65
February 12, 1973	2.5 months	7.34	2.5 months	.67
May 7, 1973	3.0 months	7.76	3.0 months	.69
October 1, 1973	5.0 months	8.03	5.0 months	.71
November 1, 1973	1.0 month	8.95	1.0 month	.75
February 1, 1974	--	8.95	3.0 months	.76
March 15, 1974	4.5 months	9.41	1.5 months	.79
April 5, 1974	--	9.41	1.0 month	.82
June 5, 1974	2.5 months	9.87	2.0 months	.85
August 1, 1974	2.0 months	9.64	2.0 months	.84
September 1, 1974	1.0 month	9.41	1.0 month	.83
October 1, 1974	--	9.41	1.0 month	.84
December 1, 1974	3.0 months	9.64	2.0 months	.86
April 1, 1975	4.0 months	9.41	4.0 months	.85
July 1, 1975	3.0 months	9.64	3.0 months	.86
August 1, 1975	1.0 month	9.41	1.0 month	.85
October 1, 1975	--	9.41	2.0 months	.86
December 1, 1975	4.0 months	9.64	2.0 months	.87
January 1, 1976	--	9.64	1.0 month	.88
April 1, 1976	--	9.64	3.0 months	.89
June 1, 1976	5.0 months	9.87	--	.89
July 1, 1976	--	9.87	3.0 months	.90
September 5, 1976	3.0 months	10.33	2.0 months	.91
October 1, 1976	1.0 month	10.10	1.0 month	.90
November 1, 1976	1.0 month	10.33	1.0 month	.91

Note: Prior to June 5, 1974, prices were set by zone. For purposes of illustration the price shown April 1, 1965 to June 5, 1974 was the price set for the zone encompassing Great Falls.

Source: Compiled by Office of the Legislative Auditor from Milk Control Division Price Announcements.

MILK INDUSTRY STRUCTURE

The milk industry can be categorized into two major segments--the producer segment and the resale or distribution segment. The producer segment is dairy farmers, while the remainder of the milk industry is involved in the homogenizing, pasteurizing, manufacturing, packaging and marketing of the milk and milk products.

Producer Structure

In dairy farming, as with farming as a whole, a trend exists toward a decreasing number of farms with the average farm size increasing. Overall milk production in Montana generally increased until 1973. In 1974 the number of cows and production both dropped but increased in 1975. At the same time the number of producers continued its downward trend. Illustration 2.5 shows a recent history of the producers and volume of milk production in Montana.

Illustration 2.5
MONTANA MILK INDUSTRY STATISTICS

Year	Number of Producers	Number of Cows		Pounds of Production		
		Total	Per Farm	Total	Per Farm	Per Cow
1968	410	20,267	49	219,493,790	535,351	10,830
1969	383	19,607	51	215,051,109	561,981	10,968
1970	346	20,567	59	222,515,733	643,109	10,819
1971	337	20,657	61	228,846,823	679,071	11,078
1972	319	20,965	66	236,795,548	742,306	11,295
1973	303	20,464	68	229,503,645	757,438	11,215
1974	295	19,479	66	219,702,142	744,753	11,279
1975	258	20,354	79	225,166,664	872,739	11,063
% Change, 1968-1975	-37%	0%	+61%	+2.6%	+63%	+2.2%

Source: Office of the Legislative Auditor's chart based on Milk Control Board data.

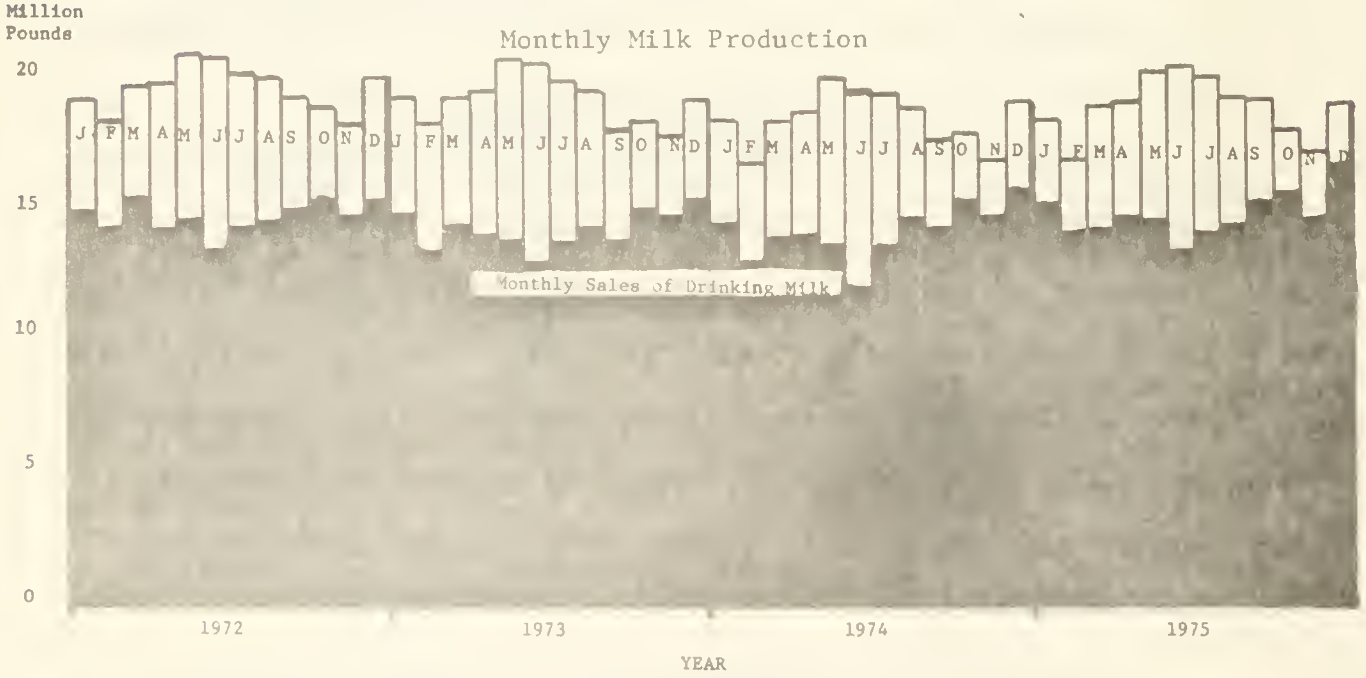
Although there have been technological advances in milk production such as sanitary milking areas, automated milking and feed systems, refrigerated milk storage and transportation of milk over long distances, the milk cow still remains the center of focus. Milk production is a function of output per cow as well as the number of cows. Output per cow can be and is influenced by feeding, breeding and management practices. In recent years changes in output per cow have had greater influence than changes in cow numbers or production. However, the farmer is still faced with one of the problems of the past--the flow of milk is difficult to control. A milk cow requires milking twice each day or its production will decrease or cease altogether until it calves again. Additionally, producers have little flexibility in adjusting production to meet demand changes. Actual decreases in production are brought about generally by slaughtering less productive cows. Such adjustments in milk production, although not permanent, are felt for several years because increases are not easily accomplished. Increases are generally brought about by bringing a new cow into the milking cycle (which takes about 30 months) or by purchasing cows already in the cycle, which is really nothing more than a shift of production from one producer to another.

The producer has an obvious problem--he cannot easily stop or start the flow of milk. Since most farmers do not have extensive storage capability and raw milk has a short storage life, milk must usually be processed and marketed every other day. This condition existed when milk controls first came into existence and continues to be the most significant single factor justifying the need for producer protection. An adequate milk supply depends almost entirely upon the existence of a producing dairy herd.

In the past, milk production during a given year from season to season varied, from the high production of May-June to low production of November-December, by as much as 25 percent. However, increases in technology relating to feed and environmental conditions for the cows have led to a decrease in this seasonal fluctuation. The seasonal fluctuations are also somewhat dependent on the calving cycle--milk production is highest immediately after calving. Montana's production over the past few years seldom varied over 15 percent. The top line in illustration 2.6 shows the monthly milk production for the past four calendar years. As shown in the illustration, milk production peaks in May and June, usually at or over 20 million pounds per month, while the season production lows, usually in February and November, range from 16.5 to 18 million pounds--an average variation in production of under 15 percent.

Illustration 2.6

MONTHLY MILK PRODUCTION AND DRINKING MILK SALES IN MONTANA 1972-75



Source: "Reported Produce Receipts" and "Reported Class I Packaged Sales." On file at the Milk Control Division.

Processing and Distribution Structure

Milk processing and distribution operations steadily became more efficient after the thirties. Improvements in transportation and capability for longer storage broke natural boundaries between markets and encouraged competition. This resulted in a decrease in the number of processors and an increase in the average size of processing plants. This trend has continued to the present, not only in Montana, but nationally, and not only in the milk industry but also in the agricultural sector in general. Illustration 2.7 shows the change in the number of processing plants since 1961 for the United States as a whole and in Montana. As shown, the downward trend in the number of processing plants in Montana is similar to that of the nation.

Illustration 2.7
NUMBER OF FLUID MILK PROCESSING PLANTS

	1961	1965	1971	1976	% Change 1961-1976
United States	7,176	5,542	2,990	1,500	-79%
Montana	93	49	31	23	-75%

Source: Staff Report to the Federal Trade Commission, Economic Report on the Dairy Industry (Government Printing Office: Washington, 1973) pp. 76, updated, and Milk Control Division Records.

The foregoing illustration shows that there were 23 processors in Montana in 1976. Nine of these processors were small producer-distributor farmers who process their own milk production. Excluding these nine, there were 14 processors purchasing and processing fluid milk. Comparing these plants to the trends in plant size, Montana is again similar to the nation. While the data was not available to make a direct comparison, illustration 2.8 shows a similar trend. That is, the small plants (under 20,000 quarts per day) are diminishing and the large plants are increasing in number in Montana and throughout the country. Such a trend is common in most segments of the agricultural industry.

Illustration 2.8

TREND IN SIZE OF FLUID MILK PROCESSING PLANTS

Size Group* (1,000 Qts/Day)	United States 1950	1961	1965	1971	Montana 1972	1976
Under 4	13,988	4,906	3,538	1,519	13	9
4 - 20	1,573	1,539	1,321	601	11	7
20 - 40	295	365	270	254	4	4
Over 40	233	366	413	616	2	3
TOTAL	16,089	7,176	5,542	2,990	30	23

* Assumes 260 processing days/year, i.e., 5 days/week
Source: Federal Trade Commission chart and OLA chart combined.

The Federal Trade Commission's 1973 Economic Report on the Dairy Industry[2] reviewed engineering studies of milk processing plants and determined, that under normal conditions, 40,000 quarts per day per plant was the minimum size needed to achieve optimal efficiency, (i.e., lowest per unit cost). The report also concluded that in many areas, plants of extreme suboptimal size (4,000-20,000 quarts per day) continue to survive and earn profits because of unusual marketing factors such as limited competition and transportation advantages which allow them to use smaller scale technology.

Montana's dairy industry seems to be following the national trend--although special marketing factors have resulted in a smaller average plant size. The greatest attrition occurred in the smaller plants--the same as the national trend.

Montana's dairy industry can be categorized into four groups--the distinguishing factor being type of plant ownership:

- --National corporate chain - owned by corporations which operate on a nationwide scale.
- --Cooperatives - owned by farmers. Except for one plant, operations of the cooperatives are localized.
- --Independents - locally owned without ownership affiliation with nationwide corporation or cooperatives.
- --Producer-distributor - owned by farmers, processing only milk produced by the farmer's herd.

Illustration 2.9, shown below, depicts the market share of fluid milk sales in pounds for the four groups during selected recent years.

Illustration 2.9

MARKET SHARE BASED ON FLUID MILK SALES IN MONTANA

	NUMBER OF FIRMS AND MARKET SHARE - FLUID MILK SALES IN THOUSANDS OF POUNDS											
	1965			1969			1972			1975		
Ownership	No.	Lbs.	%	No.	Lbs.	%	No.	Lbs.	%	No.	Lbs.	%
National Corporate Chains	4	56,387	33.0	4	66,493	36.3	4	74,236	42.0	4	79,848	45.4
Cooperatives	3	27,401	16.0	3	42,391	23.2	4	53,049	30.0	4	50,230	28.6
Independents	26	85,343	50.0	13	72,668	39.7	9	47,810	27.1	7	43,451	24.8
Producer-Distributors	16	1,620	1.0	11	1,390	.8	13	1,535	.9	9	2,083	1.2
Total	49	170,751	100.0	30	182,942	100.0	30	176,630	100.0	24	175,612	100.0

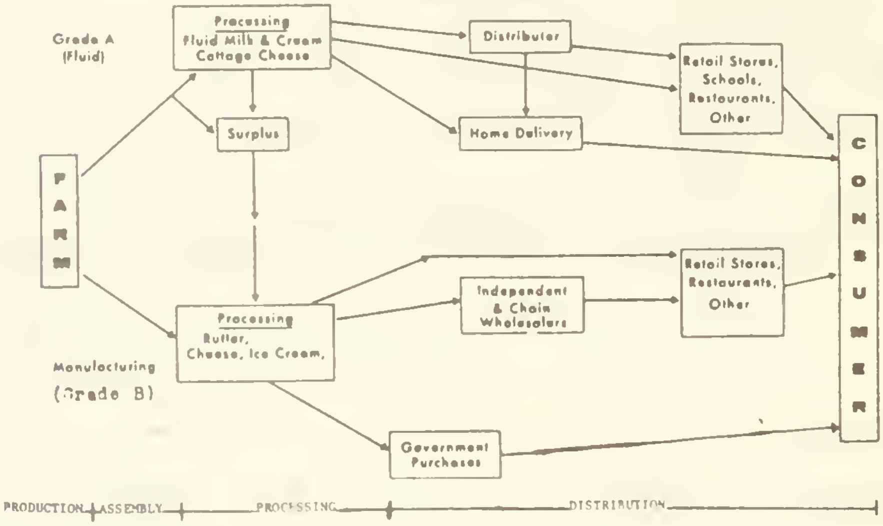
Source: Compiled by Office of the Legislative Auditor from data provided by Milk Control Division.

The continuing trend is a reduction of the market share held by independents which was assumed almost equally by the national corporate chains and cooperatives. Analysis of the data underlying the preceding table indicates that while the overall market share held by the independents has diminished, those independents remaining in business have maintained a fairly constant share of the market.

Distribution Methods

Once milk is produced, it goes to a processing plant and then into the marketing channels. The market channels are different depending upon the use of milk (drinking or manufacturing). Illustration 2.10 shows the marketing channels for the various grades and classes of milk.

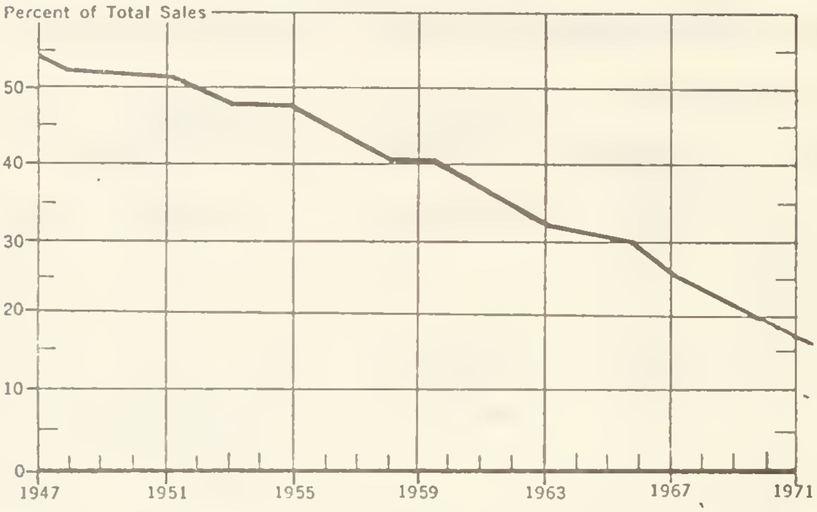
Illustration 2.10
MARKETING CHANNELS FOR MILK AND DAIRY PRODUCTS


Grade A (Fluid)
Processing Fluid Milk & Cream Cottage Cheese
Distributor
Retail Stores, Schools, Restaurants, Other
Surplus
Home Delivery
FARM
CONSUMER
Retail Stores, Restaurants, Other
Independent & Chain Wholesalers
Processing Butter, Cheese, Ice Cream,
Manufacturing (Grade B)
Government Purchases
PRODUCTION
ASSEMBLY
PROCESSING
DISTRIBUTION

Source: Compiled by Office of Legislative Auditor on basis of format in Technical Study 3, Organization and Competition in the Dairy Industry, National Commission on Food Marketing, June 1966

Just as the production and processing sectors of the milk industry have changed over the years, so has the distribution sector changed. During the early years of the milk industry, home delivery routes were the main means of distribution. The major national shift in milk distribution has been away from home deliveries to wholesale delivery at grocery stores. According to the U.S. Federal Trade Commission, 70 percent of all milk sales during the 1930's were made on home delivery routes and only 30 percent by wholesale means such as grocery stores, restaurants, etc. By 1963, the ratios were reversed with 30 percent of the distribution by home delivery routes and 70 percent by wholesale means. According to the report the trend continues at the rate of two percentage points a year.[3] As labor costs rose rapidly and productivity stayed constant, home delivery costs rose faster than other less labor intensive methods of distribution. In most areas of the nation home delivery prices rose high enough to cause some consumers to switch from home delivery to the grocery store. Illustration 2.11 on page 26 shows national home delivered fluid milk sales as a percent of total milk sales. The latest U.S. Department of Agriculture estimate shows that the national percentage in 1973 was only 10 percent home delivery. The decreasing trend of home delivery in Montana lags behind that of the nation as a whole. In 1973 (most recent data available), Montana processors sold over 25 percent of their drinking milk, by volume, in home delivery. The 25 percent excludes that milk delivered to homes by jobbers for whom data was not readily available. Nevertheless, the extent of home delivery in Montana easily exceeded 25 percent in 1973. This is due for the most part to the manner in which milk in Montana is priced. The effect of milk prices on home delivery distribution is illustrated by a staff report of the National Commission on Food Marketing which reported that, "Milk dealers interviewed by the Commission felt that if the price difference per half gallon exceeded three cents, many consumers would change from home delivery to stores."[4] The overall increase nationally for the price of a half-gallon on home delivery over store sales was 5.1 cents in 1964. In Montana home delivery and store retail prices are the same. Since retail prices in Montana are the same for home delivery or store purchases, consumers of home delivery have not been priced out of the market. Nevertheless, home delivery service in Montana is gradually disappearing just as it is nationally because of changes in consumer buying habits and the high cost of home delivery service in comparison to other forms of distribution.

Illustration 2.11
NATIONAL HOME-DELIVERED DRINKING MILK SALES



Source: U.S. Department of Agriculture, Agriculture Economic Report 207, Pricing Milk and Dairy Products, Principals, Practices and Problems, June 1971

The Economic Report on the Dairy Industry, by the Federal Trade Commission, reported that costs differ for the various types of distribution. Ranging in order from highest cost to lowest cost they are: home delivery; full service wholesale delivery to small stop customers such as restaurants; full-service delivery to supermarkets; limited-service delivery to large supermarkets; pre-ordered, centrally billed, dock delivery to supermarkets; and dock pick-up by customers at the processing plant. The most efficient method of delivery--dock pickup--has found wide usage in Spokane, Washington and other areas where resale price controls do not exist. Chain supermarkets deliver milk along with other goods to their stores. Smaller stores and independent groceries contract with wholesale suppliers to obtain milk. Thus, most retailers in such areas have the opportunity to obtain milk using the most efficient distribution methods.

There is no incentive for retailers to use such methods in Montana since all milk is priced the same at the wholesale and retail levels. A requested amendment to allow limited service delivery at discounts from the existing wholesale minimum price was rejected by the board based on hearings in January, 1976. The rejection was based upon the board's belief that such an amendment would merely transfer distribution costs from the milk processing industry to the milk retail industry without an apparent reduction in price to the consumer and lack of evidence that such a change was warranted. Consequently, the present pricing system in Montana does not encourage the use of more efficient forms of distribution. While the national trend moves from high-cost toward low-cost distribution methods, Montana continues to use high-cost methods. In rural areas of Montana some economies of scale are unobtainable. This contributes partially to the high distribution costs in Montana.

Milk Grades and Classes

Milk is produced under two sanitary standards. Grade A, the most stringent, certifies that the milk was produced under sanitary conditions making it fit for human consumption in its fluid form. Milk produced under grade B standards can be used for manufactured products only, i.e., ice cream, cheese, butter, and cottage cheese. The lower sanitation requirements result in a decrease in production costs of 15-40 cents per hundredweight (cwt). Some grade A milk, which exceeds the amount consumers use for drinking, is used in manufactured milk products.

While grade A accounts for most of Montana's milk (i.e., grade A is estimated to be 94 percent of the milk produced in Montana), some lower cost areas of the United States (such as Minnesota and Wisconsin) produce over half their milk as grade B or manufacturing-grade.

Montana categorizes grade A milk into three classes according to its use (class I, II and III). Class I consists of milk bottled or packaged in the fluid form sold as drinking milk. Class II consists of milk used in the manufacture of products for human consumption, such as ice cream, ice milk, sherbet, cottage cheese, condensed and powdered milk. Class III consists of milk used in the manufacture of butter, cheddar cheese, process cheese, livestock feed, and powdered milk for other than human consumption. All grade A milk is similar in quality in that it must meet minimum standards, but it is placed in the lower classes simply due to utilization.

Grade A milk is paid for according to its utilization. Even though it is suitable for drinking, the producer is paid at the manufacturing rate when the milk is used for manufacturing purposes. Most processing plants utilize milk in more than one class. Each producer who sells milk to a processing plant receives payment for his milk in the ratio (called blend price) that the plant utilized the milk. For example, if 75 percent of the milk went for class I use, 15 percent for class II, and 10 percent for class III, each producer who provided milk for that plant would receive payment for 75 percent of his milk at the class I rate, 15 percent at the class II rate and 10 percent at the class III rate.

Changing Demand For Milk Products

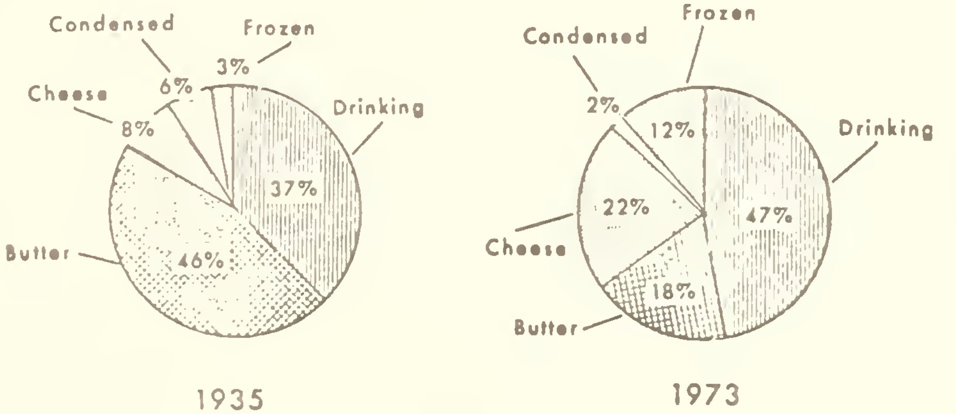
Trends in fluid milk consumption are major factors in determining milk control policies. The total volume of milk processed by milk processing companies increased steadily until it peaked in the 1950's. This increasing total consumption resulted from: increasing population, increasing per capita consumption, and movement of people from rural to city areas which increased the quantity demanded from processors. The rural population is a significant factor because they often receive milk directly from their own cows or neighboring farm cows. The effect of this shift is illustrated by the fact that in 1950, farm families accounted for 10 percent of all the milk consumed in the nation. This compares to 5 percent in 1960 and only 2 percent in 1970.

In 1950, two factors counteracted the long-run upward trend in consumption: the birth rate declined, and fluid products other than milk--such as soft drinks and frozen, concentrated juices--became more widely used. While many factors affect the demand for milk and milk products, authorities expect that milk consumption will remain fairly stable or possibly increase slightly over the next decade.

The percent of milk utilized in its main uses has also changed. Illustration 2.12 shows this change between 1935 and 1973.

Illustration 2.12

UTILIZATION OF MILK PRODUCED IN THE UNITED STATES, 1935 AND 1973



Source: Agricultural Statistics, 1974, U.S D.A., p. 371.

SUMMARY

In the 1920's and 1930's the milk industry was highly competitive. Dairymen knew that if they didn't sell milk quickly it would spoil. Thus, competition drove the price down to where they lost money. Producers, in bearing the brunt of the loss, reduced production costs by decreasing their sanitation expenses. This resulted in chaotic conditions and allowed an opportunity for dominant firms to drive the competition out of business. Since transportation was limited and expensive, surviving firms could set prices with little worry of competition from outside the milk production area.

The milk industry is openly competitive where no controls exist, but the major factors which led originally to government intervention and resale price controls in the 1930's no longer exist. With changes in technology and the introduction of refrigeration, milk now has a longer useful life. Increased technology in transportation has introduced competition on a regional scale. Finally, sanitation inspection and related requirements as well as pasteurization make it an unlikely possibility that diseased milk will reach the market.

Change has occurred on all levels and in all facets of the milk industry. Milk cans have been replaced with stainless-steel bulk tanks and the family cow has been replaced by a herd of highly productive milk cows which are milked under highly sanitary conditions. Milk is processed in larger and more efficient plants and is transported in bulk tanks or large refrigerated trucks. Distribution changed from milking your own cow to the home delivery milkman, to serve-yourself at the supermarket. There is no doubt that the milk industry of 1976 has changed from the industry of the 1920's and 1930's.

The remainder of the report comments on the need for continuing regulation of the various segments of the milk industry.

Chapter III

RESALE PRICE CONTROLS

As discussed in Chapter II, milk price controls in Montana came about solely because of chaotic conditions in the milk market. These chaotic conditions contravened the premise that an adequate supply of drinking milk is essential for good human health. Since milk prices have been controlled at all levels in Montana since 1935 the prices and quantities of milk which would have resulted under a free-market system are unknown. While we do not know exactly what would have happened without resale controls in Montana, there are indicators which can be used in evaluating the program. These indicators and the need for continued government intervention are discussed in this chapter.

INDUSTRY STABILITY

It is obvious from historical documents that the milk industry was unstable during the 1930's. Chapter II discusses more completely the nature and extent of the instability. The original legislation intended to counteract the instability was temporarily enacted in 1935 and modified and permanently reenacted in 1939.

The 1935 legislation (Chapter 189, Laws of 1935) expressly stated that a public emergency existed. The 1939 legislation (Chapter 204, Laws of 1939) recognized an ongoing need to counteract instability in the milk industry which apparently was due, in large part, to the nature of milk and milk processing and marketing conditions, i.e., the high perishability of the product. In this connection, the 1939 legislation (still in force as Section 27-401(g), R.C.M. 1947) states:

> "That investigations have revealed and experience has shown that, due to the nature of milk and the conditions surrounding the

> production and marketing of milk, and due to the vital importance of milk to the health and well-being of the citizens of this state, it is necessary to invoke the police powers of the state to provide a constant supervision and regulation of the milk industry of the state to prevent the occurrence and recurrence of those unfair, unjust, destructive, demoralizing and chaotic conditions and trade practices within the industry, which have in the past affected the industry and which constantly threatened to be revived within the industry and to disrupt or destroy an adequate supply of pure and wholesome milk to the consuming public and to the citizens of this state;"

As previously mentioned, a review of the conditions which existed in the early thirties indicates that some type of government intervention was necessary. The questions now are to what extent is the milk industry unstable today, and to what extent are price controls now needed and at what levels to insure an adequate supply of drinking milk.

The stability of the milk industry can be analyzed through standard economic theory. Economists refer to the milk processing industry throughout the nation as oligopolistic; i.e., an industry characterized by more than one firm, but not so many that they are not aware of the market actions of the other firms. Firms in this type of industry move toward inherent stability and usually the industry lacks open price competition. In oligopolistic industries with a dominant firm (one firm processes over one-third of Montana's milk) the dominant firm tends to be a price leader. This firm and the other oligopolistic firms shy away from open price competition as they realize the cost burden they must bear in price wars. The dominant firm usually will not overprice since competition is strong enough to undercut its prices and capture some of its share of the market, simply because they have such a large share of the market which makes them subject, in a price war, to larger sales losses and possibly even a reduction in their share of the market. As stated in a popular economics text, "Absence of price competition ... is what one usually observes in the real world. It is also the inference to be drawn from almost every model of oligopoly behavior analyzed."[5]

While it is possible that a dominant firm may try to buy out or merge with other firms to capture a larger share of the market this appears unlikely in Montana. The dominant Montana firm has already been found by the Federal Trade Commission to have acquired too many dairies in a given market area and now is prohibited from "acquiring any interest in any domestic dairy company without prior approval of the Commission."[6]

A change in the structure of the industry over the past few years at the retail level has resulted in a shift of market power from wholesalers in those states where there are no milk price controls to retailers. This began when chain retail food stores began vertically integrating their dairy operations, i.e., they process and distribute their own store brand milk and milk products. This integration resulted in cheaper production costs which were passed on to consumers in states without resale price controls. To compete, other chain food stores introduced milk under their private labels. This milk was often processed and packaged by existing local plants; however, if the existing plants could not provide milk at a competitive price, the supermarket chains either found a supplier who could, or built their own plants. Store brand milk now constitutes 60 percent of the drinking milk sold in surrounding milk areas in neighboring states with no resale controls. With this shift, competition in milk prices is as guaranteed as is competition between local supermarkets.

Conditions which led to the creation of milk control laws in the 1930's have changed. About the only thing that has not changed is the source of milk. However, the number of farms has dropped but milk production has remained relatively constant (see illustration 2.5 on page 18). Aside from the source of milk, the milk industry has changed dramatically over the years. The trend toward fewer and larger plants is prevalent regardless of whether states exercise control over resale prices. Major technological advances in the industry as discussed in Chapter II have also encouraged changing completely the extreme "perishability" conditions which existed in the 1930's. And finally, the stability of the industry is further aided by federal and state laws and Federal Trade Commission rulings which discourage practices (such as pricing conspiracy and predatory pricing) by firms that may be unhealthy for the industry. Consequently, it is clear that the industry has changed, particularly in the area of stability.

DISTRIBUTION EFFICIENCY

The early legislation in Montana not only recognized the need for stability in the milk industry, but also recognized the need for directness, efficiency and economy in the marketing of milk from producer to consumer. In this regard, the 1939 legislation (still in force as Section 27-401(f), R.C.M. 1947), provides in part:

> "That it is the policy of this state to promote, foster, and encourage the intelligent production and orderly marketing of milk and ... to make the distribution thereof between the producer and consumer as direct as can be efficiently and economically done ..."

The term "distribution" refers to all aspects of milk processing and distribution, from the farm to the consumer. According to a report published by the University of Illinois Agricultural Experiment Station[7] there are three potential measures of distribution efficiency: (1) comparison of distributor unit costs; (2) comparison of retail milk prices; or (3) a comparison of distributor gross margins.

It is difficult, if not impossible, to use the first potential measure--distributor unit costs, since uniform cost data is not available and in many instances is proprietary in nature where it is available.

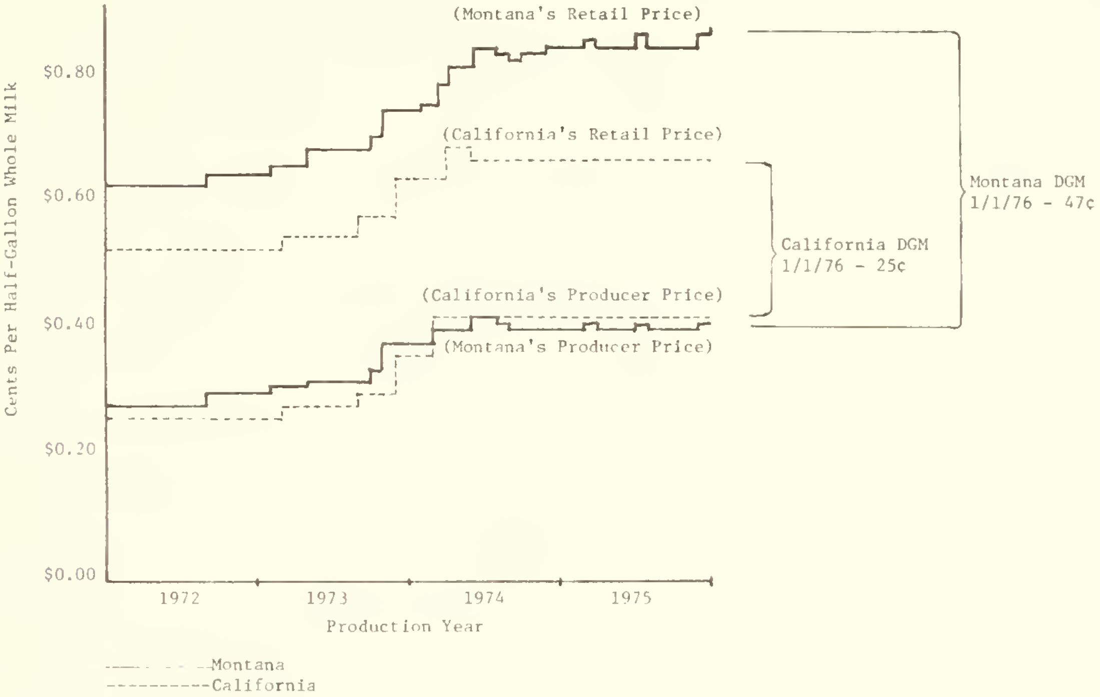
The use of retail prices also presents a problem. From the viewpoint of a consumer, a low retail price would seem to indicate an efficient market while a high retail price would seem to indicate an inefficient market. Such a comparison is unreliable as the retail price is actually a combination of the price paid to dairy farmers for producing the milk plus the cost of processing and distributing. The cost of processing and distributing, referred to as Distributors Gross Margin (DGM), appears to be the best measure of distribution efficiency. It covers the costs of receiving, processing, packaging, storing and transportation, profit and retail markup. In other words, the DGM is the difference between what distributors pay producers for milk and the retail price of milk.

Comparison With Other States

An example of comparative DGM's is depicted in illustration 3.1 which compares recent DGM's in Montana to those in California. While the milk industries in Montana and California differ in many respects, they are similar from the standpoint that both Montana and California have state producer and retail price controls. The graph illustrates the difference in DGM's under these similarities.

The difference in DGM's between Montana and California ranges around 22 cents per half gallon--California's margin is around 47 percent lower than Montana's. While California milk prices may already seem low in comparison to Montana's, consumer groups in California are advocating elimination of price control because they believe the state controlled price is still too high. If this is true, then the difference between the DGM's in Montana and California would be even greater. In California the state milk control agency very recently suspended minimum prices in a control zone encompassing the Sacramento area which has been under continuous minimum price regulation for nearly 38 years. The retail price of milk immediately dropped 13 percent or 9 cents per half-gallon of whole milk. After about 6 months the prevailing price was still 6 percent (4 cents per half-gallon) lower than the previous fixed minimum price.[8]

Illustration 3.1
COMPARATIVE DISTRIBUTOR GROSS MARGINS
MONTANA - CALIFORNIA



Source: Office of the Legislative Auditor from Milk Control Division Data and Producer Milk Pricing in California, Legislative Analyst, 1975.

The DGM in Montana can also be compared to milk markets in adjacent states such as eastern Washington, central Idaho, northern Wyoming and western North and South Dakota. In free market areas such as Boise and Spokane, considerable variation in DGM's was found to exist. Illustration 3.2 compares DGM's for Montana and adjacent milk markets for the current year. The state with the highest DGM is underscored for each month.

Illustration 3.2
DISTRIBUTORS' GROSS MARGINS IN ADJACENT MARKETS BASED UPON PREVAILING PRICE FOR 1/2 GALLON OF WHOLE (3.25%) MILK

	No Price Control		Price Control			
Date	Boise Idaho	Spokane Wash.	North Dakota	Casper Wyoming	South Dakota	Montana
Apr. 1975	$0.44	$0.43	$0.39	$0.43	$0.44	$0.45
May 1975	.44	.41	.40	.43	.44	.45
June 1975	.44	.41	.40	.43	.44	.45
July 1975	.42	.40	.41	.43	.43	.45
Aug. 1975	.42	.42	.41	.43	.43	.46
Sept. 1975	.40	.42	.42	.43	.47	.45
Oct. 1975	.41	.43	.43	.42	.46	.45
Nov. 1975	.40	.41	.44	.43	.45	.45
Dec. 1975	.37	.31	.45	.43	.44	.46
Jan. 1976	.38	.40	.45	.43	.45	.47
Feb. 1976	.37	.40	.43	.43	.44	.47
Mar. 1976	.36	.40	.43	.43	.44	.47

Source: Office of the Legislative Auditor, data on file.

As can be seen above, Montana had the highest DGM, in all but 2 instances (September and October). The two instances where the DGM in Montana was exceeded by another state were by South Dakota, which is similar to Montana: that is, government price controls at all levels. In fact, as a general rule, the higher DGM's were all in states with resale controls. In contrast, the prevailing lowest DGM was found in the adjacent non-control states.

The administrator of the Milk Control Division has stated that milk prices are higher in Montana than in other states because transportation costs are greater due to long distance distribution requirements within the state. Such reasoning is valid for some distribution points within the state, such as along the Highline and other rural areas. Since some milk must be transported, we would expect higher prices in those areas. However, the majority of milk in Montana is consumed in urban areas where processing plants are nearby. Consequently, transportation costs should not account for much of the difference in DGM's. Furthermore, the preceding illustration depicts differences in the adjacent states of North Dakota, South Dakota, Idaho and Wyoming, all of which are similar to Montana in terms of population distribution and related milk distribution problems. Accordingly, it is difficult to accept the premise that the difference in DGM's between Montana and other states is accounted for entirely by transportation costs. Currently transportation costs around thirteen thousandths of one cent ($.00013) per gallon per mile for packaged milk in bulk trucks--about 2.6 cents per gallon for a round trip of 200 miles. As can be seen, transportation can only account for a small part of the difference in DGM's.

Methods of Distribution

To a large degree higher DGM's result from the use of the more expensive methods of milk delivery. As mentioned on page 25, over 25 percent of the milk delivered in Montana in 1973 was by home delivery--the most costly and inefficient distribution method. The additional costs associated with this form of distribution undoubtedly account for the higher DGM in Montana.

There have been a number of national studies which have addressed DGM's as a measure of distribution efficiency in areas with and without governmental milk resale price controls. One study comparing distributors' gross margins in markets with controlled and non-controlled retail prices was undertaken by Illinois Professor of Agricultural Economics, Roland Bartlett. The 1965 study used data from 131 milk market areas throughout the nation for the years 1954 and 1964. Although the study used 1954 and 1964 data, there is no reason to believe the result is not valid today. In both years uncontrolled markets had the lowest distribution costs. The study summarized that:

> "Adoption of new low-cost methods and techniques in milk distribution ... took place in the uncontrolled markets, in which new competitors faced only the market power of oldline distributors. In contrast, innovation in state-controlled markets took place more slowly. The philosophy of 'protecting' the profit of most distributors whether efficient or inefficient has acted as another deterrent to needed change."[9]

Unlike Montana, a number of states where resale price controls are in effect recognize the lower cost of handling larger quantities of milk by allowing specified discounts from wholesale prices. Illustration 3.3 shows examples of discounts allowed from wholesale prices for quantity deliveries in some resale price control states. Whether or not these discounts result in lower consumer prices depends upon the extent to which the resale prices are fixed. Where there are no retail controls the savings is undoubtedly passed on to the consumer through competition. Where there are retail price controls the retailer derives the benefit of the discount.

Illustration 3.3

EXAMPLES OF WHOLESALE MILK PRICE DISCOUNTS ALLOWED FOR QUANTITY DELIVERIES

State	Percentage of Maximum Discount
Virginia	21
North Dakota	12
South Dakota	8

Source: Computed by the Office of the Legislative Auditor. The foregoing states are not intended to be all inclusive.

While the foregoing states are resale price control states, in those states where retail price controls are not exercised, discounts for limited service and special prices in special situations are the rule. In free market areas, milk retailers compete for consumer dollars with a wide variety of services and prices. Our survey of milk markets in adjacent states on May 3-7, 1976, showed milk being sold in a variety of ways and prices in the uncontrolled markets. For example, the price of whole milk in the Casper-Douglas area of Wyoming ranged from 85¢ to 94¢ per half-gallon depending upon whether it was sold in a supermarket, convenience or neighboorhood store or home delivered. Similarly, the price of milk in Boise, Idaho ranged from 69¢ to 97¢, and in Spokane, Washington from 75¢ to $1.07.

Our survey of prices in surrounding states was followed by a survey made by the board on May 17-21, 1976. That survey generally confirmed what we had found earlier. The important point depicted by the survey of prices in surrounding states is the wide range of prices in the adjacent markets compared to Montana. In the adjacent areas, customers pay more for the convenience of home delivery and for convenience buying which occurs at the convenience-type stores such as the chain convenience marts and the small neighborhood grocery stores. In this regard, most customers in the adjacent market areas, and in Montana, do their primary grocery shopping in the supermarkets or large grocery stores and patronize the convenience stores on an incidental and last-minute or convenience basis.

Accordingly, those consumers patronizing the convenience type of stores undoubtedly expect and should expect to pay more for the commodity. In adjacent states they pay more for milk under these situations--in

Montana they do not. The price is the same. A demonstration of the cost differences of the several delivery methods is also contained in the Federal Trade Commission's 1973 Economic Report on the Dairy Industry.[10] That report cited 2.1 cents per half-gallon as the cost of limited service delivery (dock delivery) to supermarkets while traditional full service delivery (stocking dairy case) costs an average of 5.7 cents per half-gallon. The report also cited a service and delivery cost of nearly 14 cents per half-gallon to restaurants. It is reasonable to assume that distributors in Montana experience the same wide range of cost, yet the Montana pricing system does not distinguish between high and low cost delivery methods but merely sets a single price for all milk, no matter how delivered. This does not mean to infer that the price of milk distributed by the more costly methods should be higher than it now is. But it is obvious that the price should not be the same as under lower cost methods of distribution.

Generally, the Montana board has reacted to introduction of low-cost methods almost precisely in the fashion intimated by the University of Illinois study. Innovation in distribution systems has been absent or slow and the philosophy has seemingly been to protect the distributors whether efficient or inefficient. The only exception the board has permitted to the uniform pricing has been the allowance of "on-the-farm sales" of a producer-distributor and this came about in the early sixties only after a state district court ordered the board to conduct an administrative hearing on the price structure in that particular marketing area. The end result was that the board allowed on-the-farm sales. In addition, in March 1975 the board allowed lower prices for on-the-farm wholesale gallon sales of milk to retailers at a price decrease of 10 cents per half-gallon. Cost differences also exist in the other distribution methods just as in the use of on-the-farm sales. However, the board has not recognized any other price differentials in its pricing policies. As a matter of fact, the board recently denied a request from an independent processor to allow discounts for less costly distribution methods, particularly dock delivery to customers because they believed it would have resulted in a higher margin for the retailer rather than lower retail prices.

Other studies also support the conclusions of the University of Illinois study regarding how resale price controls affect distribution methods. A 1964 New York report states that "The fixing of minimum resale prices as usually administered imposes a serious restraint upon the development of low-cost methods of distribution, such as large volume selling through supermarkets and dairy stores at low cash-carry prices."[11] The study further stated that resale price control tends to result in abnormally wide distributor gross margins and that lower retail prices resulting from vigorous competition encourage the introduction of new low-cost methods and practices. Similar evidence was presented in Nebraska when the supreme court declared the state's price control statutes unconstitutional in Gillite Dairy Inc. v. Nebraska Dairy Products Board, 219 N.W.2d 214 (1974). The basis for the supreme court ruling was that the setting of minimum prices precludes more efficient processors from selling at lower prices.

In 1971 and 1972 the United States Department of Agriculture Economic Research Service conducted a study of the relationships between market structure, institutions (laws, controlling bodies, etc.), and performance in 144 fluid milk markets across the nation, including the Butte and Great Falls areas of Montana. They found that:

> "In markets sheltered from competition--whether by resale price regulation, restrictive licensing, restrictive sanitary regulation, or trade practice regulation--innovativeness was retarded (and that) resale price regulation and restrictive sanitary regulation also tended to raise marketing margins."[12]

Finally, a 1975 Pennsylvania State University study[13] also looked at 83 fluid markets across the nation and found that the same circumstances existed as the 1972 U.S. Department of Agriculture study.

All of the foregoing studies conclude that resale price controls are a main cause of distributors using inefficient and costly delivery methods resulting in high milk prices. Montana has resale price controls and inefficient delivery methods and has high milk prices. Obviously, resale price controls in Montana are not promoting efficient and economical distribution of milk between the producer and consumer--irrespective of the fact that efficient and economical distribution is a requirement of the Montana milk price control law.

RETAIL PRICES

Since many of the studies mentioned in the previous section were based upon computer analyses, estimates of what milk prices would have been in the absence of resale price controls, or other situations, are available. The 1972 United States Department of Agriculture study found that in markets where the trend of shifting from home delivery to store outlets followed the national trend, the retail price was held down by 2.6 cents per half-gallon over the period from 1954 to 1969.[14] The 1965 University of Illinois study found that the distributor gross margin was 1.6 cents per quart higher in markets where resale prices were controlled than in markets where resale prices were uncontrolled in the ten years from 1954 to 1964.[15]

The setting of minimum prices for a commodity by government usually means the government intends to assure an adequate supply of that commodity. This is generally true and in Montana is particularly true since the milk price control law is expressly intended to ensure an adequate supply. As pointed out earlier in this report, side effects such as inefficiencies and high prices often result. This conclusion was expressed in the 1975 Economic Report of the President which said:

> "Current problems with dairy programs illustrate the pitfalls of heavy government involvement. State and Federal marketing order programs institutionalize a higher price for milk for fluid consumption than for processing and they restrict the free movement of raw milk. Together with import quotas and a relatively high Federal minimum price support, the measures place the dairy industry under heavy regulation and discourage efficient production. Consumers eventually pay extra for milk."[16]

Economic Effects of Price Controls

Under standard economic theory the forces of supply and demand balance at a point where all the quantity wanted of a given commodity at a given price will be supplied, without surplus or shortage. These forces regulate most of our free market system and the results are observed readily in the market place. On occasion, communication of these forces gets mixed up, as illustrated by recent history with respect to sugar, jar lids and beef. While there may or may not have been actual shortages, consumers perceived a shortage and reacted in various ways which in turn affected prices. In the case of jar lids, consumers sought and hoarded them, thereby creating temporary shortages and higher prices. In the case of beef and sugar, consumers tolerated the higher prices to a point where they switched to substitute commodities, thereby causing a surplus and lower prices. One economist expresses the view that, "A price war indicates that the (probably indirect) communication channels among firms in the market are temporarily out of repair."[17]

While mixed-up communications often result in surpluses or shortages for short periods, the cause of the mixed-up communications can sometimes be traced to price controls somewhere down the line.

If the minimum price for a commodity is established by the government or someone else below the point of balance, market forces are free to raise the price to the point of balance and the commodity will be bought and sold at the natural price rather than the government price. If the minimum price is established above the point of balance, market forces are not allowed to reduce the price. Consequently, the commodity will be bought and sold at the established price rather than the natural price. This results in a surplus of the commodity and a minimum price above what consumers would pay in the absence of control, hence, a general loss of benefit to society, i.e., reduced consumption, higher costs, and less opportunity to spend money on other consumer items.

It appears that the minimum retail price established by Montana is above the natural or equilibrium price which would be set by the competitive market forces of supply and demand. This is suggested by the fact that the retail price of milk in Montana has not generally risen above the minimum price set by the board at any point in time. Even along the Highline and in other rural areas of the state where transportation adds to the cost of milk, the price of milk remains at the minimum. Thus, normal market forces which would operate if the minimum price were set lower than the equilibrium cannot operate because the board regulations prevent selling at a lower price.

In addition, economic theory suggests that the setting of prices above where the market would have set them may result in violations of the controls. Such violations occurred shortly after resale price controls for milk were established by the federal government in 1933. Consequently, the federal government dropped resale price controls for reasons such as unnecessarily wide distributor margins, under-the-counter deals between producers and processors, and rampant violation of the resale prices. During our evaluation of the Montana milk control system we also became aware that illegal forms of competition and violation of minimum prices commonly occur in Montana.

Our interviews with a number of milk distributors disclosed that allegations of violations were common and on three occasions the interviewees admitted to their violations. Most violations involved the providing of free equipment for display or dispensing. However, one instance pertained to retail price violations and three pertained to wholesale price violations. The existence of such problems is also evidenced by the fact that in 1971, the board reported that:

> " ... feedback continues to suggest that the board's greatest enforcement problem is in the area of competition for store shelf space in wholesale accounts. Secret rebates, give-aways, combination sales and unrealistic extensions of credit are suspected."[18]

Other examples of alleged violations which we found are as follows:

1. Selling delivered milk for the on-the-farm retail price and providing the milk dispenser.
2. Milk could not be sold to certain stores because the competition owned the cooler equipment. (Several complaints about this occurrence.)
3. Two firms lost milk accounts because they refused to grant requested kickbacks on minimum prices. (Other allegations were made regarding rebates.)

4. Providing lower prices or giveaways on related manufactured products to obtain the milk account. (Several occasions of this allegation were presented.)
5. Milk dispenser equipment is provided to retaurants to tie up the account.

During the course of our evaluation the division began an aggressive program to detect and correct illegal forms of competition and violations of minimum prices. The result is that charges have been brought against nine processing plants for 84 violations which the division investigation discovered. The enforcement actions taken by the division included action against the processors involved in the violations which we became aware of during our review. These violations resulted in fines totaling $31,250. The division has suspended $27,770 under consent orders stipulated to by the department and processors whereby the processors have corrected the violations and agreed to refrain from recurrence. The suspended portions of the penalties are subject to revocation if future violations occur within one year.

Violations such as the foregoing result in a dilution of the minimum prices set by the board. Unfortunately, the diluted price is not passed on to the consumer because of the visibility of retail prices. Consequently, the consumer derives no benefit and only those in the middle of the market process benefit as a direct result of practices which are brought about by a law which is intended to benefit the consumers.

Willingness to Sell Below Minimum Prices

One indication that minimum milk prices are unnecessarily high is the willingness of milk distributors to sell at less than fixed prices when the opportunity arises. These occasions generally occur in connection with sales to public schools, state universities and institutions, and military complexes within the state.

Milk sold at public schools is normally delivered in half pint containers at a price fixed by the board. The price effective April 1, 1975, was 11.3 cents per half pint, which is about 77 percent of the minimum wholesale price also fixed by the board. Because the price is fixed, price competition is not allowed when firms compete for school business. Contact with several school districts to ascertain whether such a low price causes any serious problems in obtaining milk for the school lunch program revealed that a number of suppliers compete for school business even though the discounted price is the same for all of them. The superintendent of schools of the second largest city in Montana appeared before the board in June 1973 to request that milk price controls for sales to schools be eliminated. He suggested that the schools in his city could realize sizeable savings annually if competitive price bidding were permitted for milk. The board rejected his request because it believed approval would violate the requirement for setting minimum prices. In this regard, one school district in Spokane pays 7.27¢ per half-pint of milk while the current Montana price is 11.7¢ per half-pint.

Milk sales to state custodial institutions are also subject to board price controls. However, the price prescribed for institutions is only 8 percent less than normal minimum wholesale. The chief of the state Purchasing Bureau advised us that the state always receives an adequate number of bidders interested in supplying the institutions at the lower price, but since the price is the same for all, the award is made by a flip of a coin or by a drawing. Consequently, there is no cost savings which usually result from competitive bidding.

Willingness of the milk industry in Montana to sell at less than minimum prices is also demonstrated by milk sales to Malmstrom Air Force Base and the Fort Harrison Veterans Administration Hospital, both of which are U.S. Government installations in Montana. Sales to these installations are not controlled by the board pricing orders because of a U.S. Supreme Court ruling regarding similar circumstances in California. _Pacific Coast Dairy v. Department of Agriculture_, 318 U.S. 285 (1943). Recent contracts for milk delivered to these installations have been for prices between 16.5 percent and 54.9 percent below the minimum wholesale prices fixed by the board. The Fort Harrison fiscal year 1975 contract prices for drinking milk items, as compared to the fixed minimum wholesale prices fixed by the board, are shown in illustration 3.4.

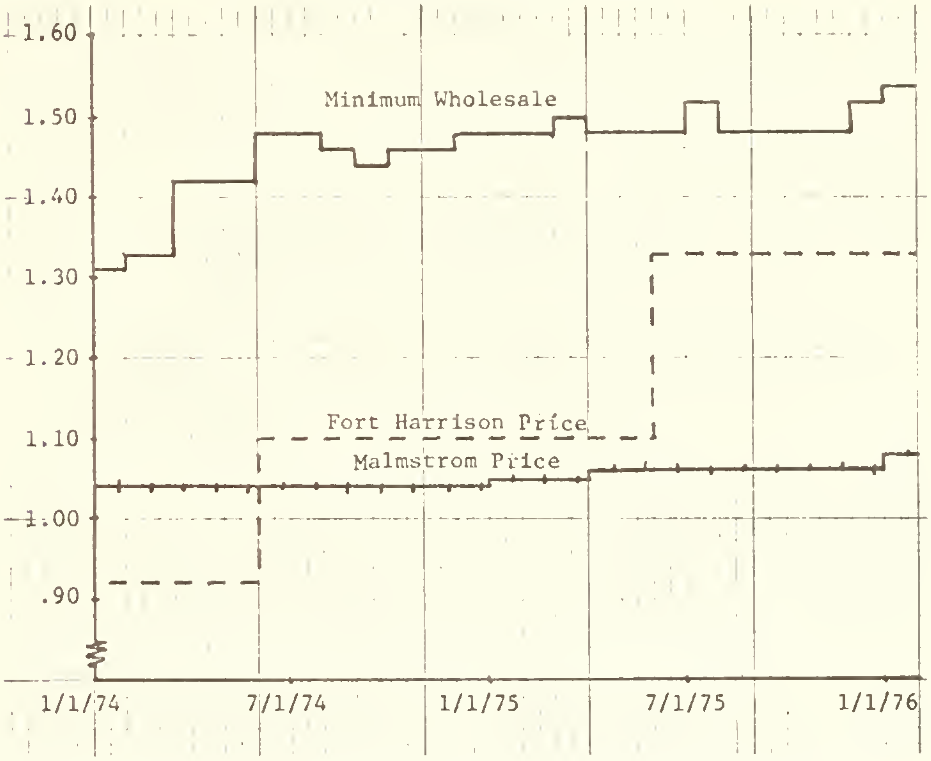
Illustration 3.4
PRICES PAID FOR MILK BY FORT HARRISON
IN COMPARISON TO FIXED WHOLESALE PRICE
Fiscal Year 1975

Item	Contract Price	Minimum Wholesale Price	Percent Below Minimum
1/2 pint whole milk	$0.075	$0.146	48.6
1/2 pint 2 percent milk	.065	.139	53.2
1/2 pint chocolate milk	.080	.155	48.3
1/2 pint buttermilk	.065	.144	54.9
5 gallon bulk dispenser	1.12 (Gallon)	1.477 (Gallon)	24.2
5 gallon bulk	1.08 (Gallon)	1.477 (Gallon)	26.9

Source: Data on file at the Office of the Legislative Auditor.

A comparison of the prices paid by Fort Harrison and Malmstrom Air Force Base for one gallon of whole milk (3.25 percent butterfat) with the minimum fixed wholesale prices set by the board from January 1974 through January 1976 is shown in illustration 3.5.

Illustration 3.5
PRICES PAID BY FORT HARRISON AND MALMSTROM AIR FORCE BASE FOR ONE GALLON OF WHOLE MILK IN COMPARISON TO THE MINIMUM WHOLESALE PRICE



Source: Data on file at the Office of the Legislative Auditor.

It is obvious from the foregoing that some segments of the milk industry are willing and able to sell milk at a price substantially below the price fixed by the board. The lower prices are attributable in part to the lower cost of delivery. The delivery methods to Fort Harrison and Malmstrom AFB utilize dock delivery, i.e., delivery to the facility rather than stocking of shelves. A recent experiment by a small independent Montana processor showed savings equal to at least 8 percent of the minimum wholesale price for limited service delivery to three supermarkets.

Finally, one retail chain store has requested to sell milk in its stores at a reduced price. It believes sales in its stores are less costly than home delivery and therefore warrant a lower price. The request was for a six to ten cent reduction per half-gallon from the minimum price set by law. The board denied the request as they believed it was contrary to state law. In 1974 this chain supported Senate Bill 379 which was introduced to provide for a store price which was less than the home-delivered price, but the bill failed to pass.

Market Price

A change in the price of milk cannot be expected overnight if resale price controls were to be eliminated. Fluctuations in the price would be expected as the forces of competition come to bear on processors and distributors causing methods of production and distribution to become more efficient.

Two dairies currently supply milk under government contracts for \$1.33 and \$1.08 per gallon compared to the fixed minimum wholesale price of \$1.54 per gallon. Since these were the lowest bids under a competitive situation they indicate the probable low for an estimated market price. However, the delivery method under the government contracts is dock-delivery. This method is less expensive for the distributor than wholesale sales to supermarkets. Therefore, to make a comparison of prices under similar delivery circumstances, the sales under government contracts should be compared to the "institutional bid price"--that is, the minimum price set by the board for sales to state institutions. That price, on January 1, 1976, was \$1.41 per gallon which is 8 cents and 33 cents per gallon more, respectively, than the prices under government contracts (\$1.33 and \$1.08).

Presently, supermarkets mark up a gallon of milk about 15 percent over their wholesale price. Distributors deliver and stock the milk, and in some instances have provided the dairy case even though it's illegal. One food chain which provides its own coolers has shown its willingness to sell milk for 12 to 20 cents per gallon less than the fixed retail price. This food chain has been the price leader in milk pricing in free market areas adjacent to Montana. Other major chains in the area set their milk prices to stay competitive with that chain store.

Finally, if the chain store mentioned earlier sets its price as indicated by its request to the board, and becomes a price leader as it has in adjacent markets, the price will be 6 cents to 12 cents less per half-gallon. Consequently, it is possible that the price controls in Montana have set the retail price about 6 cents higher per half-gallon (12 cents per gallon) than would have been set in the absence of price controls.

Data comparing retail prices in Montana to retail prices in adjacent markets without resale price controls for the most recent twelve months available showed Montana prices to be consistently higher than the prevailing price in the adjacent areas as shown by illustration 3.6.

Aside from the fact that the prevailing price for milk is lower in the illustrated adjacent areas, it is obvious that the market forces are affecting the price. In contrast, in Montana the market plays little or no role. The price is fixed by a formula rather than the market for milk itself. Consequently, it is possible that the price of milk would be lower in Montana were it not for the present system of resale price controls.

Illustration 3.6

COMPARISON OF PREVAILING RETAIL MILK PRICES MONTANA; BOISE, IDAHO; AND SPOKANE, WASHINGTON

	Prevailing Price*			Difference
Period	Montana	Boise	Spokane	Montana vs. Low Price
June 1975	85	81	78	-7
July 1975	87	80	76	-11
August 1975	85	80	80	-5
September 1975	85	79	81	-6
October 1975	85	81	83	-4
November 1975	85	83	84	-2
December 1975	87	81	75	-12
January 1976	88	83	85	-5
February 1976	88	83	86	-5
March 1976	89	82	86	-7
April 1976	89	82	83	-7
May 1976	89	79	83	-10

* Prevailing price for 1/2 gallon of whole milk.

Source: Compiled by Office of the Legislative Auditor

Changes in Consumption, Supplies, and Revenues

As stated in Chapter II, producers receive payment for their milk in the form of a weighted average, called blend price, depending on how their milk has been used. We explained earlier that the price paid producers for milk is not directly affected by changes in the resale price. However, when the resale price of drinking milk changes the quantity consumed changes. In this sense a decrease in retail prices normally results in an increased consumption and increased revenue to the farmer since the milk is drunk rather than used for manufacturing purposes. On the other hand, when the price is too high, or even if consumers believe it is too high, the amount demanded by consumers decreases and so does the farmer's revenue. Thus, it is beneficial to the dairy farmer that the retail price of fluid milk be established no higher than free market forces determine.

The relationship between prices of goods and amounts purchased has been long known to economists and understood by most people--as the price of a commodity or good increases, the amount purchased decreases. This relationship exists in the milk industry in Montana, as shown in illustration 3.7.

Illustration 3.7
MONTANA MILK PRICE AND SALES RELATIONSHIPS

	Price		Sales	
Calendar Year	Average Price Per Half Gallon in 1967 Dollars	Increase or Decrease in Price Change	Packaged Sales Class I (Pounds)	Increase or Decrease in Sale Change
1972	$0.503	--	175,095,005	--
1973	.520	Increase	169,466,406	Decrease
1974	.554	Increase	167,394,202	Decrease
1975	.530	Decrease	173,492,612	Increase

Source: Office of Legislative Auditor calculations from data on file.

The preceding illustration is based on the average price of milk in the four year period adjusted to 1967 dollars. The reason for the adjustment is to show the real price increase or decrease of milk in relation to other prices in 1967, the Consumer Price Index base year. The average price as shown is not the price in current dollars, but a price discounted by the national inflation rate. As can be observed, there were real (above the national inflation rate) price increases in 1973 and 1974 and milk consumption or packaged sales decreased during those years. However, in 1975, the real price of milk decreased (the price at January 1, 1975 and December 31, 1975 was the same) and milk consumption or packaged sales increased. The table merely shows what economic theory predicts--an increase in price will lead to a decrease in sales and vice versa.

Economists measure this responsiveness, of demand to price changes and technically call this measurement "elasticity of demand." Because of data problems mentioned before, measuring the elasticity of demand for milk in Montana is not easily accomplished. The Department of Agricultural Economics and Economics at Montana State University is currently conducting a study to measure the elasticity of milk demand in Montana and have some tentative conclusions which are briefly discussed on the next page. We can assume Montanans are typical in the consumption of fluid milk (and there is no reason to believe otherwise). Assuming this, elasticity estimates derived for other market areas yield useful estimates of the impact of milk price changes on (1) consumption, (2) expenditures of consumers for milk, and (3) revenue at the farm.

According to economic theory, the dividing point of elasticity is minus one (-1). The minus sign (-) designates the inverse relationship between price and quantity--if price goes up, quantity purchased goes down or if price goes down, quantity purchased goes up. The number represents how responsive consumers are to a price change of a commodity by changing the amount they purchase. For example, the closer the number is to zero, say -.5 as compared to -1., the more the demand for that commodity is inelastic or unresponsive. The closer the number is to zero, the less responsive consumers are to price changes. If the measurement goes beyond -1., say -2 or -3, the demand is said to be responsive, or elastic. The demand for luxury items such as jewelry is very elastic, i.e., the higher the price rises the less consumers purchase.

An elasticity study published in the Journal of Dairy Science in 1964 placed the elasticity of demand in the short run for milk at

-.66.[19] Economists with the Council on Wage and Price Stability[20] and the United States Department of Justice[21] believe that reliable estimates of elasticity are between -.1 and -.7 with higher values corresponding to long range patterns. The range of these estimates is confirmed by research at Purdue University which estimated the elasticity to be -.14 in the short run and -1.63 in the long run.[22] Similarly, the results of the elasticity study being conducted by Montana State University place the short run elasticity at -.32 and a long range elasticity of -2.66. In the MSU study, the short run refers to the quarter of the year when price changes occur. The long run represents occurrences three to four years later.

The policy implications of these findings by MSU are important to those in the processing and distribution segment of the milk industry. They indicate that during the first couple of months after a 10 percent increase in the price of milk, the buying public will only decrease its purchase of milk by about 3 percent, with the end result being an increase in revenue to those who raised the price. However, this increase in revenue is short-lived, for within four years consumers will have decreased purchases of milk by about 27 percent. The assumption of an elasticity of -.1, -.4, and -.7 for the Montana market can reasonably be used to demonstrate the results of milk overpricing at the retail level. These values are used in illustration 3.8 to demonstrate the short run effects on producers' incomes, consumers' expenditures for milk, and consumers' purchases of milk on the premise that the retail price of milk is excessive by 12 cents per gallon.

Illustration 3.8

ESTIMATED ANNUAL EFFECT AT VARIOUS LEVELS OF ELASTICITY OF A MILK RETAIL PRICE WHICH IS EXCESSIVE BY 12 CENTS PER GALLON

Level of Demand	Effect at Each Level of Elasticity		
Elasticity	Decrease in Gallons of Milk Consumed	Consumer Overpayment	Decrease in Dairy Farmer Income
-.1	154,000	$2,177,958	$ 80,000
-.4	629,000	1,422,622	327,000
-.7	1,128,000	631,111	587,000

Source: Office of Legislative Auditor calculations based on statistics from the Milk Control Division

The preceding illustration shows the effect of a milk price which is excessive by 12 cents per gallon. If the demand for milk is relatively inelastic (-.1), consumers will continue to purchase milk meaning, in a sense, that they are willing to pay almost any price for it. If this is the case, consumers will pay more than they should for the milk ($2,177,958 per year at an elasticity level of -.1) while at the same time 154,000 gallons less of milk will be purchased which, in turn, results in a loss of income to dairy farmers of $80,000 per year both as a result of less consumption by consumers and due to the fact that the excess milk is used for manufacturing purposes rather than drinking purposes. On the other hand, if the elasticity is greater (-.7) consumers will not tolerate much of an excessive price and will not buy as much milk. Consequently, much less milk will be consumed (1,128,000 gallons per year at an elasticity level of -.7) and the consumer overpayment will be much less--only $631,111 per year. In addition, dairy farmers will lose significantly more income--$587,000 per year.

Under the present price setting procedures, some of the implied overpayments are channeled into the processing and distribution segment of the Montana milk industry--processing plant and retail stores essentially. Others are lost because milk is not being used at its highest and best economic use--i.e., drinking. Deregulation of resale prices would allow a decrease in prices to the consumer resulting in a decrease in consumer payments. This decrease in consumer payments would be borne entirely by the processors and distributors. However, the resultant decrease in revenue to the processors would not necessarily be a reduction of profit but could substantially be absorbed by increased efficiency in the distribution of milk and increased consumer consumption. Once again, we point out that since Montana has had milk price controls at the retail level since 1935, data is not available to estimate the true competitive price with an absolute degree of reliability.

There is strong evidence that milk in Montana is overpriced. This conclusion is evidenced by the fact that (1) Montana's DGM's are generally higher than surrounding states (see illustration 3.2 on page 38), (2) milk in Montana is not being sold above the minimum price fixed by the state (see page 46); (3) milk is delivered to the consumer's doorstep for the same price as it is available in the dairy case (see pages 41-42); (4) milk is sold to federal installations, state institutions and schools at a price less, and substantially less in some cases, than the fixed price (see page 49); (5) firms are evidently willing to competitively bid for opportunities to sell milk at a price which is less than the fixed price (see page 50); and, finally, (6) some firms are willing and in some instances have sought authority to sell milk for less than the price fixed by the state (see page 52).

There is also strong evidence that the demand for milk in Montana corresponds closely to the price, i.e., consumers will decrease their purchases of drinking milk if the price is excessive and in fact have done so in recent years (see page 57).

The foregoing factors have had an adverse effect in two respects. First, Montana consumers are not drinking as much milk as they would if the price of milk were lower. This is adverse from the standpoint that the prevailing thought is, and Montana law expressly states, that milk is necessary. Second, dairy farmers are adversely affected because reduced consumption means less milk is used for drinking (class I) purposes and more milk is used for manufacturing purposes (classes II and III). Consequently, the dairy farmer is paid less.

The reason for the impact upon the farmer is simply that the fluid milk is not being consumed because of overpricing and rather is paid for in class III--the lowest price the farmer receives. If the milk is utilized as fluid milk packaged sales, the farmer receives a higher payment because a greater percentage of his production is at class I. Thus the increased payment to the dairy farmer.

PROCESSOR VIEWS ON PRICE CONTROL

The milk processing industry in Montana consists of producer-distributors, independents, cooperatives and national chain processing plants. The illustration on page 23 shows the approximate percentage of the fluid milk market that each of the four categories share. There are currently nine producer-distributors operating in the state who have their own dairy herd and process the milk which they produce within their own dairy plant. Their operations are considered small and they do not purchase milk from other producers. The producer-distributors have only about one percent of the Montana milk market.

The other three categories are conventional processors in that the plants process milk purchased from producers. The categorical distinction relates principally to the ownership of the processing plants. There are currently six independent processing plants operating in Montana. The term independent is applied to these plants because they are locally owned without ownership affiliation with national dairy corporations or cooperatives. The independents have about 25 percent of the Montana fluid milk market. The largest of these plants has about 7 percent of the milk market while the smallest has less than 3 percent of the market.

There are four cooperative processing plants in Montana. These plants are owned by the producers as members of the cooperative. The Montana cooperatives are not large by Midwestern standards and have about 29 percent of the Montana fluid milk market. The largest of these plants supplies 12 percent of the milk market while the smallest supplies about 4 percent.

The other four processing plants in Montana are owned by national chain corporations. One of the plants is an integrated operation--the milk processed in this plant is distributed to only the retail stores owned and operated by the chain. The other three plants in this category are owned by a single national corporation. The chains supply about 45 percent of the Montana fluid milk market. Individually, the plants all have about the same capacity, the smallest processing about 10 percent of the market and the largest processing about 14 percent.

The independent processors and cooperatives in Montana generally favor continuation of resale price control. A recent decision by the board to not raise the minimum resale price to accommodate an equivalent

2 cents per half-gallon increase granted to the producers resulted in substantial objection by most of the independent processors. In a meeting on May 8, 1976, a group of independent processors petitioned the board to rescind the decision and require that the 2 cents be passed through to the consumers. The board declined to do so but rather left the matter of pass-through an option of the processors. Therefore, the processors' group obtained an injunction from a state district court to set aside the board order on technical grounds rather than the merits of the price increase granted to producers. The processors' group alleged that the order to raise the producer price without automatic pass-through to the consumer was issued without appropriate notice. In the meantime, the board conducted a formal hearing on the matter and upheld its prior decision, i.e., to raise the producer price by 2 cents per half-gallon without mandatory pass-through to the consumer.

The board's position is that neither the law nor the board's pricing orders prevented processors from raising prices above the minimum, i.e., the processors could raise the price if they wanted to. However, the processors suggested that due to extensive milk regulation for over 30 years, the minimum price has become the maximum price. Several of the independent processors present at the meeting suggested that the competition in the market would not allow increased producer prices to be passed through to the consumer without raising the minimum resale prices, i.e., they suspected that some processors and/or retailers would not pass through the increase by raising the retail price to the consumer. Consequently, in order to stay competitive, they could not raise their price and would have to absorb the increased cost resulting from a higher producer price. One of the independent processors said he had a net loss in 1975 and wanted to know where the board thought the revenue would come from to cover the $80,000 which the recent producer price increase would cost his firm. Although not projecting losses, several other independent processors expressed similar cost increases without a corresponding increase in revenue. However, one independent processor favored the action of the board and has since petitioned for a further 2-cent reduction of the retail price and distribution margin. The latter request is still pending for hearing before the board.

As mentioned previously we provided a preliminary draft of our report to each of the firms operating processing plants in Montana to obtain the industry views regarding our conclusions and potential recommendations. For the most part, the comments made by the processors regarding the potential elimination of resale price controls can be divided into several categories which are addressed below. However, the following does not necessarily reflect the attitudes of the national chain corporations because those organizations have not formally responded to our preliminary draft at the date the report was released.

Possible Surplus Milk from Adjacent States

Some independent processors and cooperatives expressed concern that elimination of resale price controls would make it possible for depressed (surplus) milk to be marketed in Montana from nearby states. The premise underlying this concern is that milk surplus to one area could be hauled and sold at lower prices in Montana in spite of the increased transportation cost and still provide a greater return to the seller in the adjacent state than if it were processed as surplus in the original production area. Shipment into Montana is not likely to occur for two reasons: First, the system used by the board to establish minimum producer prices for Montana now contains provisions to assure that producer prices are comparable to those in nearby areas. Second, since the processors in nearby states are all subject to producer price controls, fluid milk packaged for sale must be paid for at Class I prices rather than surplus prices. Thus, it appears that concern over surplus milk from nearby areas is unwarranted because the producer price will always be comparable without any significant cost advantage to out-of-state processors.

In addition, some of the processors in Montana have a natural transportation/location advantage over firms which might choose to bring surplus milk in from outside the state. The advantage, in conjunction with local support, possible retail licensing and a prohibition of sales below cost, would serve to further alleviate any concern over the shipment in of surplus milk.

Possible Higher Milk Price in Rural Areas

Currently, the retail price of milk is uniform throughout the state--urban and rural areas alike. Industry spokesmen advised that without price controls, the price of milk in rural areas would probably be higher than the price in urban areas. This is probably true--under a competitive market situation, higher prices in remote areas might be expected. Unit costs for delivery to remote areas are higher for all commodities and there is no reason to anticipate milk to be an exception to this rule. However, anticipation of a difference in price between urban and rural areas does not necessarily mean that the current retail price of milk will increase above its current level. It is certain that there will be a range of prices just as there now is in the adjacent states without resale price controls. The price will depend upon competitive forces rather than an artificial fixed price.

Possible Higher Milk Price in Small Stores and for Home Delivery

Some expressed the belief that the price of milk in small grocery stores and for home delivery would be higher because volume discounts given to large stores would not be available because of lower volumes. Under a situation of open competition, it is possible that the price of milk will be higher in small neighborhood grocery stores, convenient stores and for home delivery than in the high-volume grocery stores. This is to be expected and is a situation which currently exists for most food items purchased from convenience stores. That is, you pay more under such circumstances for most items than you would in a supermarket. There is no reason to think that milk would be different.

Possible Higher Prices for Low Income and Senior Citizens

One independent processor expressed concern that low income and senior citizens would be adversely affected by the elimination of resale price controls because they purchase mostly from neighborhood stores or home delivery routes where it is possible that prices would be higher than in supermarkets. In this connection, an official of the U.S. Department of Agriculture Food and Nutrition Service in Montana told us that about 85 percent of the food stamps are used in supermarket stores (i.e., stores with monthly gross sales over $25,000) and that about 14 percent of the food stamps are used in the grocery stores including large grocery stores and convenience-type stores. Less than one percent of the food stamps are used to pay for milk on home delivery routes.

Similar views are expressed by representatives of the Montana State Low Income Organization and the state Department of Social and Rehabilitation

Services. Representatives of the Montana State Low Income Organization expressed the belief that the milk price controls in Montana have not benefited the low income population in the state. They also expressed the view that the majority of the low income population does not benefit from home delivery services in that it is not available in many communities and in many cases the dairies will not provide the service to low income people due to possible credit risks.

A representative of the state Department of Social and Rehabilitation Services said that the price of milk directly affects both the programs and the people served by the department. In addition to the low income population, the price of milk affects the aged and the handicapped. Sales of milk on home delivery routes and in convenience-type markets does not have a significant impact on the aged, according to the representative of the department. She said that not many of the aged patronize the convenience-type markets and home delivery routes, particularly since most of them do their general grocery shopping at supermarkets anyway. In this regard, she said that supermarkets or large grocery stores are easily accessible to most of the aged population and that the department and volunteer organizations such as senior citizen groups have programs to assist those for whom access to supermarkets is difficult.

Possible Limitation to Single Brand

Dropping of resale price controls will enable the introduction of more efficient methods of distribution of milk. However, these methods evolve around volume deliveries to single locations by either limited service drop delivery or dock pickup by the retailer. It has been suggested that consumers suffer under volume delivery techniques because selection for consumers is limited to only a single brand of milk.

This possibility could result because capturing of a greater market and increased volume is the key to more efficient distribution and ultimately savings for the consumer. As volume to single locations increases the unit cost of handling decreases. However, in both nearby states where supermarket prices are lower, the consumer still has a choice of brands--although the one brand is generally higher priced. This is no different than circumstances that consumers are now faced with when purchasing most other products and is even less significant since milk is produced, processed and marketed under stringent quality control requirements.

Possible Predatory Pricing by National Firms

A number of independent processors and cooperatives voiced concern that in the absence of price control the large national corporations and chain supermarkets would use predatory pricing practices to increase their share of the milk market and eventually force them out of business. One processor commented that with assurance against predatory pricing (such as sales below cost) by the national chain distributor in Montana, his company could compete and continue in operation without resale price controls.

This was essentially the same comment expressed by several other small processors except that their concern was directed toward supermarket chains. The concerns of the processors in this regard are discussed more fully under "Sales Below Cost", page 78. While they generally believe they are as efficient as any processing plant and often had a transportation/location advantage, they feared that the supermarket chains would employ subterfuge and cutthroat or predatory pricing techniques. They believed that the supermarkets would bring in milk from outside the state, cut the price until the local dairy industry, both producers and processors, were out of business and then raise the price. They expressed the belief that the end result would not be lower prices for the consumer but rather elimination of local jobs and, eventually, higher prices.

One of these processors commented that in an unlimited competitive market he would be out of business in nine months because he does not believe he has the financial resources to withstand the pricing subterfuge which he contends would take place. He believes that if he could last two years, the free market pricing would settle down and he could survive.

The possibility of predatory pricing always exists. The processor who expressed concern about the national chain processing plants believes that violation of minimum wholesale prices is currently occurring. By the same token, any processor willing to violate the current milk pricing laws would probably also sell below cost under total decontrol. However, sales below cost with the intent of eliminating competition is a more serious offense than violation of state minimum wholesale prices, i.e., a violation of federal antitrust laws versus state milk laws. Most supermarket chains in Montana are not integrated with milk processing plants and as a result, have no proprietary interest in the processing or in the location of the milk supply. Accordingly, an efficient processing plant with a natural transportation/ location advantage would be in a position of effective competition with out-of-state suppliers.

One way predatory pricing practices can be controlled to a degree is through a posting requirement. A posting requirement requires that processor-distributors post or file the exact price at which they are selling milk. This enables competitors and regulatory agencies to observe the pricing actions, making it easier to detect unfair or predatory pricing practices. In Colorado, for example, the posting law has provided the basis for major legal action against dairy firms who have apparently engaged in predatory practices such as giving kickbacks and rebates to selected milk retailers.

Regarding the aspect of the independents being forced out of business, this seems to be a natural phenomenon which occurs regardless of price controls. The illustration on page 23 shows a decline since 1965 from 26 independent plants to only seven in 1975. Further, the volume of milk processed and supplied by the independents decreased from about 50 percent to about 25 percent (see illustration 2.9 on page 23). The processing and supply of this decreased volume was absorbed by the two national chain corporations, and by the four cooperatives, all of which have operations, facilities and employees within and around the state. Consequently, it is not so much a case of total discontinuance of an activity as it is a shifting of the operations from one type of ownership to another. This is and has been the trend for many years.

Whether this eroding of independent ownership would continue or possibly accelerate under free market conditions is unknown. It is a fact that states without resale price controls have experienced a higher rate of small processing plant decline than those states which set resale prices. This was pointed out in the Pennsylvania State University study on the _Impact of State Regulation on Market Performance in the Fluid Milk Industry_,[23] which concluded that resale regulation was associated with a greater number of plants and that it provides protection for relatively inefficient plants (often smaller plants), keeping them in business and providing a sufficiently wide margin so that they need not innovate. However, the Federal Trade Commission's 1973 Economic Report on the Dairy Industry concluded that smaller-size plants continue to survive and earn profits because of limited competition and transportation advantages.[24] In Idaho, a state which does not control resale prices, there are 18 small and six medium-sized independent processing plants in operation. In addition, the experience in California where minimum prices were suspended suggests that smaller processors can compete effectively. The California Department of Food and Agriculture, in the report, A Summary of Observations on the Suspension of Minimum Retail Milk Prices in the North Central Valley Marketing Area Zone 1 indicated that eight small processors supply milk in the geographical area where prices were suspended. The state agency found that there were no adverse effects on these processors as a result of the suspension of minimum retail prices even though they supplied and continue to supply only about 10 percent of the drinking milk.[25]

Possible Untimely Response to Unfair Practices Act Violations

The Unfair Practices Act (Chapter 1, Title 51, R.C.M. 1947) is intended to protect Montana businesses from predatory practices which prevent or destroy competition. Concern was expressed by some processors that the response time for enforcement of the Unfair Practices Act is not sufficient to protect them against these practices, i.e., before correction takes place under the provisions of the act the firm would be already out of business. Because of this, processors do not believe the act was of much value.

Additional discussion of unfair practices legislation is presented in a succeeding section of the report; however, the state and its agencies have authority under the Administrative Procedures Act (Section 82-4204, R.C.M. 1947) to adopt emergency rules to correct conditions which an agency finds creating an imminent peril to the public health, safety or welfare. Such rules can be adopted immediately without the usual 20 days' notice and may be effective for not more than 120 days. Should circumstance justify, the emergency rule can be adopted as permanent through the normal hearing process. This process allows the board to act swiftly and temporarily when circumstances warrant.

Possible Audit of Processor Cost Records

Several of the processors suggested that processor costs should be audited to determine whether processor costs are out of line with the minimum wholesale prices set by the board. While such an audit would undoubtedly provide that information, it is not relevant to the question of whether resale price controls should be continued or discontinued. A similar audit of middlemen in the market of other commodities would also undoubtedly show whether their costs were high, low or average. The basic question is whether continued government involvement in the resale price process is necessary to insure an adequate supply of milk to the consumer. We have concluded, as set forth in this report, that price controls inhibit the introduction of new lower cost means of distribution, both for delivery and for retailing and as a consequence, the cost to the consumer is higher than it would be if there were no resale price controls over milk.

EXPERIENCE OF OTHER STATES WITH ELIMINATION OF PRICE CONTROLS

To evaluate the potential effect of dropping resale price controls we contacted a number of states which eliminated resale price controls in the recent past as well as one state (Oregon) which eliminated resale price controls about 26 years ago. There does not appear to be a specific pattern among these states suggesting that price decontrol does or does not affect the incidence of decline of independent processors. The state experiences are as follows:

Virginia--Minimum retail prices were discontinued in July 1974. The state allows volume discounts of up to 13 percent for delivered milk and 21 percent for dock pickup. The delivered discounts are most prevalently used. There was generally very little change in consumer prices when the minimum retail price control was removed; however, occasional weekend specials occur where milk is sold for less than net wholesale. Overall, the producer prices of milk were not adversely affected by the removal of retail price controls. Virginia retained authority to temporarily set minimum retail prices in event of market disruption and has used that on two occasions since July 1974 for certain geographic areas--once when the retail price fell below the producer price and another time when the price fell about 25 cents below the prevailing retail price. Five processing plants have closed since minimum retail prices were dropped. However, the Virginia milk control authorities do not attribute the closure of the processing plants solely to the absence of retail price controls, but indicated that there were also other factors involved.

Oregon--Resale price controls were discontinued in 1950. Processing plants currently operating include six national chains and 31 independents of varying sizes. No control over the wholesale and retail distribution of milk exists at this time. The administrator, Milk Stabilization Division, Oregon Department of

Agriculture, advised us that he is currently concerned about nine smaller independent plants located in smaller communities due to price competition from larger plants. The price competition is caused largely by supermarkets purchasing from out-of-town processors who use high volume limited service delivery to the larger stores. This procedure leaves only the low volume, high cost market for the local processor that has not chosen to expand his market beyond the local community. The administrator favors full resale price controls to protect the smaller processors but believes enactment of legislation for such price controls is not possible because of objection by consumer groups. Rather, he anticipates legislation to prohibit sales below cost to protect the local processors.

Georgia--All price controls were discontinued after being ruled unconstitutional in 1967. We were advised that the retail price of milk increased, but there were no price wars and that the trend of losing processing plants continued at about the same rate as under price control. Currently there are 25 processing plants including national chain plants, co-op plants and six small independents. The co-ops process the largest milk volumes. The price in Georgia is about the highest in the country although in the past few years store specials indicate some price competition.

Louisiana--The state discontinued retail price control in 1974 but retained wholesale controls which allowed volume discounts. Processing plants currently in operation include eight national chains, two cooperatives and 18 independents. Recently, a court ruling permitted purchasing of milk from Mississippi at prices lower than established minimum wholesale. To counteract this decision the milk commission instituted a dock pricing concept which allowed the processor to set his own price. This concept has resulted in severe price competition which may cause five independents to cease operations. The average consumer price has decreased about 14 cents per half-gallon since competition became permissible. The principal source of competition is in supermarkets where retail specials on milk have been run at less than the farm price of milk. Since the court ruling, Louisiana enacted legislation which became effective October 2, 1976, eliminating minimum wholesale price control and establishing prohibition of sales below cost--6 percent above the producer price. The director of the Louisiana Dairy Stabilization Board is hopeful that enforcement of this legislation will partially stabilize the industry.

Mississippi--The state terminated all milk price controls including minimum price regulation in June 1970 after ten years of price control. After the milk price controls were repealed, some areas of Mississippi experienced price instabilities which lasted varying lengths of time in the different areas. However, prices in much of the state remained stable. The long range effect seems to be that prices have steadily increased along with the increase in production, processing, and distribution costs. Some milk plants have been closed and there has been a reduction in the number of producers since 1970; however, the Mississippi officials are unable to determine whether these changes are due to price deregulation or normal industry trends. The current price of whole milk in Mississippi ranges from 95 cents per half-gallon to $1.15.

The preceding experiences by other states lead to few, if any, uniform conclusions about the effect of the elimination of resale price controls. In Georgia retail prices went up, but the prices went down in the other states. The decline in the number of processors continued but it is uncertain whether the decline is abnormal. The end result is that the effect of the elimination of resale price controls in Montana is unknown, but one factor is certain: the price of milk would be set by the market rather than by government.

UNFAIR PRACTICES LEGISLATION

As previously mentioned, the milk price control laws in many states include or consist only of legislation which prohibits unfair trade practices such as sales below cost, rebates, etc. According to the U.S. Department of Agriculture, 28 states have such legislation in various forms.[26] The extent and manner in which these 28 states regulate unfair trade practices is depicted in Appendix B on page 107.

Montana is one of the 28 states with milk control laws which prohibit unfair trade practices. The Montana milk control law (Section 27-414, R.C.M. 1947), gives the department general power to adopt rules and regulations governing fair trade practices in the milk industry and specifically prohibits the following unfair trade practices:

> "(1) The payment, allowance, or acceptance of secret rebates, secret refunds, or unearned discounts by a person, whether in the form of money or otherwise.
>
> (2) The giving of milk, cream, dairy products, services, or articles of any kind, except to bona fide charities, for the purpose of securing or retaining the fluid milk or fluid cream business of a customer.
>
> (3) The extension to certain customers of special prices or services not available to all customers who purchase milk of like quantity under like terms and conditions.

> (4) The purchasing, processing, bottling, packaging, transporting, delivering or otherwise handling in any marketing area of milk which is to be or is sold or otherwise disposed of at less than the minimum wholesale and minimum retail prices established by the board.
>
> (5) The payment of a price lower than the applicable producer price, established by the board, by a distributor to a producer for milk which is distributed to any person, including agencies of the federal, state or local government."

In addition to the foregoing, the department has adopted regulations (8-2.12(2)-S1210, Montana Administrative Code), which specifically prohibit other unfair trade practices as follows:

> (1) The compensation of, or other preferred treatment of, a producer of milk, including a chain store or grocers' association, by a dealer, either directly or indirectly because such purchaser takes delivery elsewhere than at the location where such milk shall be used, consumed or resold, or for transporting such milk to any other location after accepting delivery thereof. The term purchaser in this context shall not include milk dealers or outside salesmen who distribute fluid milk processed by a milk dealer.
>
> (2) The giving or agreeing to give, discounts, whether in the form of money, merchandise, coupons, stamps, prizes, bonuses or premiums in any form or the buying or selling of any merchandise conditional upon the sale of fluid milk products which would directly or indirectly reduce the monetary value of such products below the minimum price established by official order of the Board of Milk Control.
>
> (3) The using of such items as bottle caps, cartons, stamps, coupons, or any other item distributed with milk sold at retail or wholesale to qualify a person to receive a prize, award, or any other thing of value, which would directly or indirectly reduce the monetary value of fluid milk or fluid milk products below the minimum retail or wholesale price established by official order of the Board of Milk Control.
>
> (4) The selling by any distributor to any store, chain store, supermarket, restaurant, marketing cooperative, or other wholesale customers, under any mutual or secret agreement, arrangement, combination, contract or common understanding whereby the ultimate wholesale price for milk received by the distributor is less than that fixed in the applicable official price order of this Board.
>
> (5) The solicitation or acceptance from any distributor by any store, chain store, supermarket, restaurant, marketing cooperative, or other wholesale customer, under any mutual or secret agreement, arrangement, combination, contract or common understanding whereby the ultimate wholesale price for milk received by the distributor

is less than that fixed in the applicable official price order of this Board.

(6) The engaging by any distributor in the sale or offering for sale to wholesale customers of fluid milk and cream products under the jurisdiction of the Board in combination with the sale of uncontrolled food items when the uncontrolled food items are sold or offered for sale at less than cost, or at unrealistically low prices. Such sales dilute the actual price for milk ordered and intended by the Board in its official price fixing orders.

(7) The acceptance or solicitation by wholesale customers of fluid milk and cream products under the jurisdiction of the Board in combination with uncontrolled food items when the uncontrolled food items are accepted or solicited for purchase at less than cost to the distributor or at unrealistically low prices.

(8) The luring away of competitor's salesmen through the device of according to the salesman or salesmen unrealistic bonuses, commissions, fringe benefits or other incentives.

The essence of the foregoing is that Montana has adopted very broad and encompassing unfair trade practice laws and regulations governing the milk industry in Montana. These laws and regulations, combined with the fact that the board has broad authority (Section 27-415, R.C.M. 1947,) to initiate and conduct investigations of everyone involved in the milk industry, would appear to give the board broad power to discover and eradicate unfair trade practices.

In addition, the board is an agency of the state Department of Business Regulation. The Department of Business Regulation is responsible for administering and enforcing the Unfair Practices Act (Chapter 1, Title 51, R.C.M. 1947) which applies to the milk industry as well as other industries and which specifically prohibits (1) sales below cost, (2) secret rebates, (3) and any other practices which are intended to prevent and/or destroy competition. Accordingly, the board, division and department have, under the milk control statutes and the unfair practices statutes, broad authority to discover, investigate and eliminate unfair trade practices in the milk industry.

Sales Below Cost

While virtually all of the information and data available indicates that elimination of resale price controls will benefit society by way of more efficient processing and lower prices, the fact remains that the processing segment of the milk industry in Montana fears the open competition which would result if resale price controls were eliminated. Virtually all of the processors with whom we discussed the issue of elimination of price controls expressed two major points. First of all, they generally expressed the view that they could compete with any other firms provided the competition was fair and in the public interest. Secondly, they all expressed a genuine fear of predatory trade practices by the national dairy firm which currently sells 37 percent of the milk in Montana. The processors contend that this firm in particular, and possibly other national firms, would react to the elimination of resale price controls in Montana by dropping the retail price of their milk to a point, possibly even below cost, where the smaller domestic processing firms are forced out of business. Once this is accomplished, according to some of the domestic processors in Montana, the national firms will absorb greater shares of the market in Montana resulting in a virtual monopoly situation which, in their opinion, would ultimately result in higher prices to the consumer.

While there is no doubt that the fear expressed by the domestic processors is genuine, there is no certain means of determining whether or not it is valid. Concern as to what will happen without some of these controls is logical, particularly since the milk industry in Montana has operated for over 40 years under what amounts to be total government protection.

Although the fear of open competition is genuine, there is substantial evidence, as previously mentioned elsewhere in the report, to indicate that the fear may be unfounded. First of all, economic theory suggests that firms in industries such as the milk industry (oligopolistic) have a tendency to avoid open predatory pricing which results in price wars because they have so much to lose. Secondly, there are states, as previously mentioned, that do not have resale price controls and these states, including some adjacent to Montana, have relatively stable milk industries.

In addition to the foregoing, it is evident that the extensive price controls which Montana has had for over 40 years have not in themselves been effective in curtailing the circumstances which the domestic processing industry apparently fears. As previously pointed out, one firm currently holds about 37 percent of the milk market in Montana. This firm has achieved this share of the market under milk price controls which are admittedly among the most stringent in the nation. In addition, this firm, as well as nearly all of the other firms, both domestic and national, operating in the state have been penalized for predatory trade practices. As mentioned on page 48, the division has in recent years carried out investigations to detect and correct unfair trade practices. Numerous firms have been fined and consent orders entered into curtailing unfair trade practices.

Aggressive enforcement action of a similar nature is also being undertaken in other states. For example, in Colorado, a state in which resale milk prices are not set by the state, several distribution firms in the dairy industry are under investigation by a state grand jury for unfair trade practices. The grand jury has handed down indictments charging dairy product kickbacks of nearly $1 million to supermarkets and other retail customers. Similarly, in Missouri, a state which also does not set resale milk prices, a large national dairy firm has recently paid fines in excess of $54,000 and agreed to refrain from unfair trade practices such as kickbacks, free equipment, cash gifts and rebates between milk wholesalers and retailers. Several other dairy firms in Missouri have also been charged with similar practices.

The significance of the foregoing is that unfair trade practices in the dairy industry are not limited to Montana. It appears to be a fact of life in the dairy industry that such practices occur with or without resale price regulation. In areas where resale prices are set, the occurrence of such practices is more probable--simply because the freedom of firms to engage in such practices is more circumscribed.

While the state's Unfair Practices Act (Title 51, Chapter 1, R.C.M. 1947,) prohibits sales below cost as a general rule in Montana, the milk laws and regulations do not specifically prohibit sales below cost. As a practical matter, sales below cost are prohibited by virtue of the fact that the state sets minimum milk prices which, in effect, preclude sales below cost. Repeal of the division's authority to set minimum milk resale prices without some corresponding action to prohibit sales below cost would weaken the division's ability to assure fair competition in the dairy industry.

As shown in Appendix B on page 107, 25 states prohibit sales below cost at either the wholesale or the retail level or both. Many of these states allow sales below cost under certain circumstances as depicted in Appendix B on page 107. These circumstances include: to meet competition, for government contracts, for liquidation, and for damaged goods. In this regard, the state Unfair Practices Act also allows sales below cost under such circumstances.

Standby Powers

Currently the board is required to set milk prices throughout the state. Elimination of all or part of this mandatory requirement to fix the price of milk presents the possibility of a future competitive situation which is unknown. Some segments of the milk industry believe that the elimination of the price controls will adversely affect them and possibly the industry as a whole. This fear is contradicted by economic theory, facts, and the experience in states which do not have resale price controls but still have adequate supplies of sanitary drinking milk at prices generally below Montana's. Nevertheless, a fear of the unknown remains which cannot be resolved with any certainty simply because the industry has been under government price control for so long.

Some states have offset the fear of a catastrophe in the milk industry through measures prohibiting unfair trade practices such as sales below cost and by giving the state milk control agency the prerogative to act in extreme cases. In North Carolina, for example, the state milk control agency has the authority to set the resale price of milk if market conditions warrant it, which so far they have not. In Virginia, which has wholesale price controls, the state milk control agency has specific statutory authority to intervene in the market and set a minimum retail price for milk upon the determination that absence of a retail price is adversely affecting an adequate supply of milk. Specifically, the Virginia law provides that the state milk control agency may not set retail prices unless it determines:

> "... that the absence of a minimum retail price has caused or is about to cause a disruption in the Virginia milk market or some segment thereof which is likely to depress the producer price or has caused or is likely to cause a substantial reduction in competition between processor-distributors in an area, so as to adversely affect the public health and welfare which requires an adequate supply of milk at reasonable and fair prices." (Underscoring supplied)

The state milk control agency in Virginia has the authority to act with or without a public hearing depending upon whether emergency conditions exist in the market. The agency has the statutory authority to temporarily set prices for a period no longer than 60 days during which time the board can conduct a hearing to confirm or rescind its emergency order.

Accordingly the milk control agency in Virginia has well-defined authority to act in the public interest when emergencies arise.

We recognize the fact that unbridled action aimed at destroying competition could ultimately be ruinous if the public became the victim of only a few processors, distributors and retailers. This, combined with the fear, whether imagined or real, expressed by the processing segment of the industry, would appear to be reasonable grounds for the board to have standby price-setting powers such as those in Virginia. These powers should be expressed in the law and should be limited to situations in which temporary emergency action is warranted to avert or correct chaotic conditions which adversely affect the public interest.

Although the milk control laws are silent with respect to emergency or standby powers, another state law currently provides the board and similar agencies with the authority to act swiftly in the public interest. The Administrative Procedures Act (Chapter 42, Title 82, R.C.M. 1947,) specifically empowers the board, as well as other such agencies, to adopt emergency rules without prior notice or hearing, in instances where they determine that there is imminent peril to the public health, safety or welfare. The statute (Section 82-4204(2), R.C.M. 1947,) provides that the temporary rule may be effective for a period not longer than 120 days, during which time the agency can hold a hearing to determine whether or not the temporary rule should be made permanent or rescinded.

Accordingly, the board currently has the specific authority to institute emergency measures under the Administrative Procedures Act. This authority could be used by the board to set resale prices in the event that chaotic market conditions adversely affecting the public interest ensued subsequent to the elimination of resale price controls in Montana. We have not defined such chaotic conditions because we believe the definition of such conditions is a task more suitable for the board and the milk industry in Montana.

Retail Licenses

The Montana milk laws currently provide for the licensure of producers, distributors, and jobbers. There is no requirement nor statutory authority under the milk laws to license retailers, i.e., those firms engaged in the retail segment of the milk industry such as the supermarkets and grocery stores. Consequently, the board does not license retailers of milk.

Some other states, some of which control resale prices and some who do not, require that retailers of milk be licensed. For example, in Virginia, a state which sets producer and wholesale prices but not the retail price, retailers are licensed. The Virginia milk control law defines a "distributor" as including anyone who sells drinking milk at wholesale or retail. The Virginia law also allows the state milk control agency to revoke a license after notice and hearing, for several reasons, including in the public interest and violation of the milk control laws and regulations.

In North Dakota, the law requires that all such processors, distributors and retailers be licensed by the state milk control agency. In this regard, the law specifically states that there will be no monetary charge for the license and the license is good until there is a change in ownership or location, the license is suspended or revoked, or the business becomes inactive.

As previously mentioned, the Montana milk control law does not require nor authorize the licensure of retailers in the milk industry. In our discussions with many of those involved in the milk industry in Montana, it became obvious that the lack of retail licensure was a weakness in effective control of the industry. The board and the administrator of the division emphasized the fact that non-licensure of the retail segment of the industry was a key problem in effective enforcement of unfair trade practices. They expressed the view that many of the trade practices such as secret rebates, furnishing of equipment, etc., which adversely affect the milk industry eventually materialize at the retail level. They said that such practices cannot be effectively controlled unless the board has the authority to suspend or revoke the right of such firms to sell drinking milk in the retail market.

Producers and processors with whom we discussed the possibility of retail licenses generally agreed that enforcement of the state milk control laws could be more effective if the retail segment of the industry were licensed. In addition, a representative of the Montana Food

Distributors' Association, a private association which represents nearly the entire wholesale, distribution and retail food industry in the state, advised us that the association would probably not oppose a retail license requirement for those firms who sell milk provided the license was a no-cost, lifetime type of license such as that currently issued in North Dakota. He expressed concern, however, that such a license might eventually turn into a revenue measure and that it might be used to unreasonably control retailers.

The Montana law should be amended to provide for the licensing of those firms which sell milk at retail. The law could specify, as it does in North Dakota, that no monetary charge be made for the licenses, and that the licenses are good until there is a change of ownership or location, the license is suspended or revoked, or the business becomes inactive. The tenure of the license and whether or not a charge is warranted are matters which can be resolved by the board and the industry. Irrespective of these features, the purpose of the requirement for licensing at the retail level should be solely to enhance enforcement of the state milk control laws rather than to raise revenues or limit or control the number of licensees.

CONCLUSION

The state legislature has clearly established the fact that the milk price control laws in Montana are primarily intended to insure an adequate supply of milk for the people in Montana and to make the distribution of milk between the producer and consumer as direct, efficient and economical as possible. To accomplish these objectives and overcome chaotic conditions which existed in the 1930's, the law provided for a complex system of milk price controls at the producer, wholesale and retail levels. While this system of milk price controls appears to have been faithfully carried out by the board and has unquestionably accomplished the objectives of the law over the years, the necessity of its continuance in certain areas is questionable. Possibly in recognition of this, the board has recently taken some measures to allow the competitive forces to play a greater role in the resale price setting process, e.g., raising the producer price and leaving the pass-through of the price to the discretion of the processor-distributors. In this connection, the board deserves recognition for striving to insure an adequate supply of wholesome milk at a reasonable price throughout the state.

However, there is evidence to indicate that the conditions which prompted the enactment of the milk control laws in the 1930's have changed to the extent that certain provisions of the milk price control law are no longer warranted. Specifically, there is substantial evidence to indicate that milk price controls at the resale (wholesale and retail) level in Montana are no longer warranted and, in fact, most states have found that resale price controls over milk are unneeded.

There is also substantial evidence to indicate that milk price controls at the resale level are no longer in the public interest and that such controls at the resale level may have an adverse effect upon both consumers and dairy farmers--the very ones the law is supposed to benefit. It is evident that consumers are paying more for milk in Montana than they should be and that as a result, consumption of drinking milk is less than it would be otherwise. It is also evident that dairy farmers are suffering a loss of potential income because of the reduced consumption and underutilization of drinking milk. Accordingly, it is fairly conclusive that continuation of milk price controls at resale levels is no longer warranted and not in the public interest.

While it is conceivable that elimination of resale price controls may cause hardship for some elements of the wholesale end of the milk industry (particularly small processors) who are inefficient, there is no evidence that the law was intended to primarily benefit this part of the milk industry or perpetuate inefficient or uneconomical operations. To the contrary, the law expressly provides that the distribution of milk from the producer to the consumer shall be as direct, efficient and economical as possible. If the intent of the law is otherwise, then the law should be changed. Irrespective of this, there has already been a substantial attrition of processing plants in Montana--from 93 in 1961 to 23 in 1976. Nine of these 23 plants are producer-distributors which account for approximately one percent of the total milk sales. This trend is not unusual considering that it is also representative of what is happening nationwide, not only in the milk industry but also in agriculture in general. The trend is probably inevitable and will probably continue--the latest casualty occurred in April 1976. This does not mean that all small independent processors who are efficient will not survive. They have certain advantages in Montana notwithstanding their efficiency, such as transportation/location advantages and the advantage of local support by consumers.

The foregoing advantages, combined with (1) efficiency, (2) assurance of fair competition, and (3) standby powers for the board to act in extreme cases should result in the survival of the independent firms within the milk industry in Montana just as it has in other states. Assurance of fair competition is an essential element. The chaotic conditions of the 1930's were evidenced by competitive practices which were unfair. Some unfair competitive practices are currently occurring in Montana. Montana currently has laws which, if effectively enforced, would preclude the use of unfair competitive practices in the milk industry. The department has attempted to enforce these laws in the recent past and should aggressively enforce them in the future.

Although continuation of resale price controls is no longer warranted, sales of milk and milk products below cost should be explicitly prohibited. In addition, the board should have some degree of standby powers to act in extreme situations. These powers should be limited to situations in which temporary emergency action is necessary to avert or correct chaotic conditions which might arise at various locations in Montana.

Inasmuch as certain aspects of the present system of milk price controls in Montana are no longer needed and are no longer in the public interest, the following changes should be made:

1. The *mandatory* provisions in the law that *require* the setting of resale (wholesale and retail) prices should be repealed so that minimum wholesale and retail prices are no longer *required* to be set by law.
2. Sales of milk and milk products below cost should be expressly prohibited by law.
3. The Board of Milk Control should be granted standby powers to temporarily set resale prices in extreme situations to avert or correct chaotic conditions which might occur in various areas of Montana.
4. The board should discontinue, in an orderly fashion, the setting of resale (wholesale and retail) milk prices.

5. The board and the department should continue an aggressive and routine program of investigation of competitive practices in the milk industry in Montana to ensure fair competition and to ensure industry compliance with the fair practices provisions of the milk control law and the Unfair Practices Act.
6. The current milk control law should be amended to provide for the licensure of those firms which sell milk at retail.

The foregoing changes would serve the public interest by protecting the producing segment of the milk industry, ensuring a continuous and adequate supply of milk for drinking purposes and ensuring that the competitive practices in the milk industry are fair and in the public interest. Because no one is certain as to the immediate effects of the elimination of price controls, change should be accomplished in an orderly fashion so as to assess and soften the impact of the change on the Montana milk industry. As part of this process the board should collect data for study and evaluation of the effects of the elimination of resale price controls on the various segments of the milk industry and the consumer.

RECOMMENDATION

We recommend that the board and department:

1. *Support legislation to:*
    - *(a) repeal the mandatory provisions of the current law which require the setting of resale prices for milk.*
    - *(b) prohibit sales of milk and milk products below cost.*
    - *(c) obtain standby powers to temporarily set resale prices in extreme situations.*

    (d) *provide for the licensure of firms which sell milk at retail.*

2. *Discontinue the setting of resale prices in an orderly fashion if appropriate legislation is enacted.*
3. *Conduct an aggressive and routine program of investigation and enforcement against unfair competitive practices in the milk industry.*

Chapter IV

PRODUCER PRICES

Chapter III pertained almost exclusively to resale price controls, i.e., price controls set by the state at the wholesale and retail levels of the milk industry. As mentioned earlier in the report, the state also sets the minimum price of milk at the producer level, i.e., the price paid to the dairy farmer for the milk his dairy herd produces. This chapter discusses various aspects of the process used by the state to set the price of milk at the producer level.

Section 27-407, R.C.M. 1947 directs the board to fix minimum producer prices by means of a flexible formula that brings about such automatic price adjustments as are justified on the basis of changes in production costs and milk supply. This is accomplished by means of a formula which is separate and distinct from the formula used to set resale prices.

The law intends that setting minimum producer prices will contribute toward assuring an adequate supply of grade A milk for consumption by the public. The experience of government regulation suggests that minimum producer prices have assisted in accomplishing this goal--a surplus of drinking milk exists in Montana as depicted by illustration 2.6 on page 20. The setting of minimum prices enables the producer to recover production costs plus a reasonable profit upon achieving average efficiency in the production of milk. Such a recovery enables dairy farmers to continue producing milk for the public.

PRICE SETTING

Prior to conversion to the flexible formula the Montana board used dairy farm costs of production to set prices. The costs were accumulated through infrequent cost studies which were performed at the request of various producers in the dairy industry. The producers requested a study of production costs apparently because milk payments were too low to permit a profit. If the results of the cost study showed inadequate minimum prices to meet the cost of production, the board made an upward adjustment of prices. This cost study process consumed considerable time and necessitated substantial time lags before the minimum price changes occurred. The statutory change requiring the use of the formula for setting prices substantially reduced the time lag and considerably reduced the gap between rising production costs and corresponding rising milk payments. A timely response is necessary for adjusting minimum producer prices because the Montana producer lacks the market power to force price increases as costs rise. This inability to force price increases results principally because processors have a significant bargaining advantage--the daily flow of milk at the farm cannot be readily controlled; storage of raw milk is limited by its short life and storage facilities at the farm; and a large number of producers competing to sell to only a few processors as previously discussed in Chapter II. Consequently, the responsiveness of the formula is important to producers. The current responsiveness of the formula is illustrated by illustration 2.4 on page 17. The formula approach was implemented in lieu of the cost studies on May 1, 1972 and has been used since.

The content of the present formula for setting minimum producer prices differs from that originally implemented. The original formula included 18 indices or factors for setting both resale and producer prices. Each index/factor was assigned a judgmentally-weighted value for calculation of an overall trigger mechanism which resulted in periodic changes in milk prices. The assigned weighting of each index/

factor was not determined statistically but rather was based on recommendations of a consultant and the judgment of the board. There have been several changes to the formula since implementation--the most significant being a split in the indices/factors to provide for separate producer and resale formulas. Another change brought about at the request of the producers was the weighting assigned to dairy feed and hay. These and other requests are apparently made because those involved in the dairy industry did not believe the formula was responding favorably to industry.

Currently the formula used to set producer prices uses the following indices/factors:

1. Percent Unemployment - U.S.
2. Percent Unemployment - Montana
3. Weekly Wages - Total Private (Revised and Seasonally adjusted)
4. Prices Received by Farmers - Montana
5. Mixed Dairy Feed Price
6. Alfalfa Hay Price
7. Prices Paid by Farmers - U.S.

As previously mentioned the formula responded rather consistently since its implementation in May 1972 until the middle of 1974 resulting in an increase in the producer price. However, during the last half of 1974 and 1975 the formula indices seemed to stabilize and producer prices leveled off as shown by illustration 2.4 on page 17. In response, the producers sought a revision of the formula essentially to enable raising the minimum prices. In response to this request, the board held hearings in January 1976 to gather evidence to make a decision regarding possible revision of the formula. Part of the evidence submitted was cost of production data for four producers for a 3-month period which had been obtained from the Cooperative Extension Service at Montana

State University. According to the data, the average cost of producing a hundredweight of milk for the four producers combined was $10.85 for the 3-month period while the individual average ranged from $10.12 to $12.03. The board recognized that the average costs of four producers was insufficient to accept as representative of all producers but considered the testimony along with other testimony and again revised the producer formula. This decision was challenged by a group of four processors on the technical grounds that it was not established as a result of appropriate hearing process. While the case was pending, another hearing was held (July 23, 1976) and the decision reached was the same as in the previous hearing, i.e., raising the producer price from $9.87 per hundredweight to $10.33 per hundredweight.

Interestingly, one producer testified at the January hearing in opposition to modification of the formula. His reasons related primarily to the "elasticity of demand" (discussed on page 56 of this report), that is, consumers would decrease the quantity of drinking milk purchased with a resultant lowering of the blend price. This particular dairy farmer advised that his cost of producing milk was $8.45 per hundredweight based upon the board's format for computation of production costs. In other words, his costs of production were $8.45 per hundredweight compared to $9.64 which he received under the current formula and $10.10 under the revised formula.

FORMULA CHANGES

The effect on the producer price of changes in weights or indices/factors can be tested simply by making mathematical calculations in the formula with new input data. However, difficulty arises in attempting to measure the propriety of the new price. Currently, the board has no systematic means of knowing whether or not the producer prices being set by the formula are equitable, i.e., high, low or on target in terms of what is appropriate and fair to the producer. This is obvious from the fact that as mentioned previously, producers testified that their costs ranged from $8.45 per hundredweight to $12.03 at a time when the formula set the price at $9.64 and $10.10 per hundredweight. At best the board has only inadequate documentation to verify whether the formula sets equitable producer prices. The board relies entirely upon the formula to set the prices, the exceptions being those instances where producers request a change in the formula which subsequently results in a price increase. Whether such price increases are too much, too little or just right is unknown and is a matter of conjecture. The producers and processors with whom we discussed the formula process generally agreed that the formula is a far more responsive approach to price setting than the prior method of hearings and occasional cost studies. At the same time they almost universally expressed concern over the fact that the board does not have the data on the cost of producing and processing milk in Montana which it needs to make informed decisions. In this connection, the board expresses the view that the price decisions are made by the formula, not the board, and that the best measure of the adequacy of the price is the supply of milk. In other words, if there is enough milk the price is right. If there is too much milk or too little milk the price is too high or too low.

The board's contention that the price decisions are made by the formula is true to a certain extent. However, the board is responsible for the formula and for making decisions about the composition and operation of the formula, and indirectly, the industry affected by the formula changes. In addition, the board is responsible for knowing whether the formula is operating properly. As previously mentioned, the formula has been changed four times since its inception in 1972, presumably because various segments of the industry convinced the board that the formula was not responding properly and changes were warranted. This is an indication that the prices being set by the formula process were out of step with what was actually being experienced by the industry.

The last documentation that the board obtained which provided a basis for evaluation of the formula was a study in 1971 of producer production costs completed prior to the adoption of a flexible formula in 1972. This cost data was used to drop the price at the date the original formula was implemented because the initial impact of the formula would have raised prices too much at one time. Consequently, the cost data was introduced to lower the formula price. In this connection the board does not collect cost of production data on a continuing basis but rather relies on other occasional and less reliable methods of obtaining data such as occasional hearings and informal feedback from the various vested interests in the industry such as the producers in their area of the state. At the January 1976 hearing, for example, the board heard evidence that the cost of milk production for five producers ranged from $8.45 to $12.03 per hundredweight. The board does not have sufficient reliable information to know whether these costs are accurate or inaccurate, comparable or incomparable, yet they were considering a revision of the formula which would increase the price.

One other means the board has very recently used to roughly assess the propriety of the price set by the formula is the data being compiled by the Cooperative Extension Service at Montana State University.

Testimony regarding cost of production data for four producers was recently provided the board in conjunction with the most recent change in the producer formula. This data was compiled by the Cooperative Extension Service. The Cooperative Extension Service project began late in 1975 as a pilot or test project for the purpose of assisting in the management of dairy farms. It is a voluntary program currently involving seven producers around the state. These producers voluntarily provide raw data to the Cooperative Extension Service on a monthly basis. The data is compiled by the Cooperative Extension Service and monthly reports are returned to the producers showing, among other things, their costs of production.

The usefulness of the Cooperative Extension Service data is limited because (1) it is voluntary, (2) it is not representative of the industry, (3) it involves a small number of producers, and (4) it is a new program. In addition, the extension service cost system inflates costs about 20 to 30 cents per hundredweight because it does not reduce production costs by the value of three-day-old calves which are sold and which are essentially a by-product of producing milk. Available data shows that costs of producing milk vary between producers and that use of a small sample of producers does not provide sufficient representation to evaluate the adequacy of the formula price.

While there may be others, we found that two states have a systematic process of compiling uniform cost of production data for producers in its milk industry. These states are North Carolina and California. In North Carolina, the state has the authority to set producer, wholesale and retail milk price controls like Montana. However, the state does not set the wholesale and retail prices, but only sets the producer prices. The producer prices are set as a result of testimony and evidence gathered at hearings rather than by formula as is the case in Montana. In addition, the North Carolina Milk Commission engaged North Carolina State University to devise and operate a cost of production study to determine the actual costs of milk production on a continuing basis.

The North Carolina project is similar in some respects to the MSU-Cooperative Extension Service project in Montana. In fact, the North Carolina project is being carried out by the cooperative extension program at North Carolina State University. It began in 1973 and initially involved a random sample of 85 producers selected to be representative of the milk industry in the state. The producers participating in the study are periodically rotated and replaced with other producers to maintain the representativeness of the sample and to broaden the impact of the study. Each of the producers in the sample systematically submit data to the University which compiles it and sends cost of production reports back to each producer. In addition, the University furnishes cost of production data on a quarterly basis to the North Carolina Milk Commission which uses the data to determine the propriety, adequacy and impact of the milk prices it sets for producers. In other words, the North Carolina Milk Commission not only sets the prices of milk at the producer level, but also has a system to determine whether or not the prices are appropriate.

In California, the state conducts a survey of milk production costs, determines the average cost of producing milk, and publishes a bi-monthly Standard Production Cost Index. The survey and published cost index data encompass a sample of about 50 producers who participate in the program on a voluntary basis. The data is used as a guide by the state in setting the price paid to milk producers.

The voluntary nature of the system in California has been found to have an adverse effect upon the price setting process. There are indications that the sample of producers is biased because the efficient producers either do not participate in the survey or drop out of it, resulting in cost data which is obtained from and based upon the least efficient producers.[27] In this regard, it is to the theoretical advantage of all producers to have the milk prices set on the basis of data from the least efficient-higher cost producers. This would result in milk prices being paid by processors and ultimately by consumers which are higher than warranted. Mandatory participation by a broad cross section of producers would preclude this by ensuring that the data is representative of the milk industry.

CONCLUSION

As mentioned at the outset of this chapter, the Montana milk control law specifically states the board shall establish milk prices on the basis of a formula which brings about such automatic price changes as are *justified on the basis of production costs*. The board currently does not use a systematic means of determining whether the milk prices *set* by the formula and paid to producers are appropriate in terms of actual production costs or whether *changes* in the milk price, brought about by the producer price formula, are in fact warranted on the basis of actual production costs. Also the board has no accurate means of determining whether or not the price changes allowed by the board actually accomplish the objectives of the price change, that is, to compensate the producer for higher costs.

Inasmuch as the board is responsible for the formula and the setting of the price of milk at the producer level, the board should have some systematic means of feedback on the impact of its price setting policies. The board needs a system which furnishes routine and timely data on the actual cost of milk production and the impact of component price changes on production costs. It is unreasonable to expect an agency, such as the board, to set and change prices without knowing the impact of those prices upon the group the price regulation is intended to benefit. In this type of situation, management should have, in effect, a circular or loop system which (1) assesses the need for price change, (2) makes the price change, and (3) determines the impact or effect of the price change. Currently, the board has only two elements of such a system.

The board should explore the feasibility of developing a system of actual production cost feedback such as the system being used in North Carolina and the system being tested by the Cooperative Extension Service at Montana State University. The system could be used on a routine basis in conjunction with (but not in lieu of) the producer-formula, i.e., the formula sets the price and the production-cost system provides feedback on the appropriateness and impact of the price. This could be accomplished in conjunction with the Cooperative Extension Service project at Montana State University.

The production-cost system should consist of a sample of producers who represent a broad cross section of the milk production industry. The producers chosen in the sample should be required by the board to participate in the system and those participating should be furnished with monthly reports on their cost of production. Such reports would assist them in the management of their dairy operations and may assist them in becoming more efficient. For this reason, the producers participating in the system should be gradually rotated and replaced by other producers. If the system were undertaken in conjunction with the Cooperative Extension Service, extension service personnel in the field could assist the producers in the project such as is currently done in North Carolina. In addition, board audit personnel could be used to periodically test and verify the data being supplied by the various producers.

A feedback system such as the foregoing would provide the board with factual information about the adequacy of the price formula, need for price changes, and the impact of price changes made by the formula.

RECOMMENDATION

We recommend that the board consult with the Cooperative Extension Service at Montana State University to explore and, if appropriate, to develop and implement an information system for use in conjunction with the formula price process which systematically compiles data on the actual cost of producing milk in Montana.

BUTTERFAT PROCEDURES

During the course of discussions with producers and processors it became obvious that the issue of measuring butterfat content may be a problem in the industry. The butterfat content of milk is a substantial factor in the milk pricing and payment system. Producers are paid on the basis of the butterfat content of the milk their herds produce. Producers producing milk with a butterfat content of less than 3.5 percent are paid less while those over 3.5 percent are paid more. Specifically, an upward or downward adjustment of the established class I price is made of 7.5 cents for each 1/10 of 1 percent deviation in butterfat. Consequently, milk with a high butterfat content results in a higher per unit payment to the producer while milk of a lower butterfat content results in a lower payment.

Several problems appear to exist. First, some of the producers are not confident that tests are correct, primarily because the tests are for the most part performed by the processing segment of the industry without any independent verification.

Second, there is evidence that the sampling procedures used to obtain milk for the butterfat tests are inadequate and subject to question. In this regard, the administrator of the division conducted a study in January 1975 which showed that the procedures needed to be improved.

Third, there are various methods in use for conducting the tests of milk for butterfat. Some processors use the traditional Babcock test using a centrifuge, while other processors use a more recently developed electronic analyzer test. In some cases processors conduct the tests for each incoming shipment of raw milk while in other cases it is done on a weekly composite basis or 15-day composite basis. We have not evaluated the merits of either type of test and whether the results are the same or different. The point is that different methods are being used.

Finally, in addition to the fact that the responsibility for butterfat testing is divided between the Department of Livestock and the board, at the present time no one independently tests or verifies the butterfat testing procedures or results on a routine basis.

In addition to the foregoing, a question exists as to the appropriateness of a price and payment system which results in an incentive for the production of milk with a high butterfat content. This is questionable because a trend exists to greater consumption of milk with a lower butterfat content; the average butterfat content of fluid milk consumed has decreased steadily from 3.4 percent in 1967 to 2.9 percent in 1976 and there has been an increase in the value of butterfat for Class II and Class III uses.

Based on the foregoing, the board should consider the propriety of basing milk prices and payments on a system which induces the production of milk with a high butterfat content. The board should sponsor or undertake a study to determine whether the current system of butterfat sampling, testing, and milk pricing is appropriate, make administrative changes in conjunction with the Department of Livestock where possible, and propose legislative changes where necessary.

RECOMMENDATION

We recommend that the board undertake a study to examine the current procedures used by the milk industry and the board to sample, test and price milk on the basis of butterfat content.

FOOTNOTES

1/ U.S.D.A. Agricultural Marketing Service, *Prices and Consumption of Dairy Products With Price Supports and Milk Orders*, (G.P.O.: Washington, D.C., 1972) Agricultural Economic Report #226, p. 3.

2/ *Staff Report to the Federal Trade Commission*, *Economic Report on the Dairy Industry*, (G.P.O.: Washington, D.C., 1973) p. 78.

3/ *Ibid*., p. 35.

4/ *Ibid*., pp. 92-93.

5/ Ferguson, C.E., *Microeconomic Theory*, third edition (Irwin: Howewood Ill., 1972) p. 364.

6/ *Staff Report to the Federal Trade Commission*, *Op*. *Cit*., p. 17.

7/ Bartlett, Roland W., *Is State Control of Consumer Milk Prices in the Public Interest?*, (Urbana, Illinois: University of Illinois Agricultural Experiment Station, 1965) p. 5.

8/ *A Summary of Observations on the Suspension of Minimum Retail Milk Prices in the North Central Valley Market Area Zone 1*, (California Department of Food and Agriculture March 17, 1976) pp. 1, 9.

9/ Bartlett, *Op*. *Cit*., p. 22.

10/ *Staff Report to the Federal Trade Commission*, *Op*. *Cit*.

11/ *Market Structure*, *Competition and Regulation in the Distribution of Fluid Milk*, Report to Gov. Rockefeller, New York, April 1964.

12/ Manchester, Alden C., *Market Structure*, *Institutions*, *and Performance in the Fluid Milk Industry*, (U.S. Department of Agriculture: 1974) Agricultural Economic Report No. 248, p. 20.

13/ Shaw, C.N., and M. C. Hallberg and C. W. Pierce, *Impact of State Regulation on Market Performance in the Fluid Milk Industry*, (Pennsylvania State Agricultural Experiment Station Bulletin #803, 1975) p. 28.

14/ Manchester, *Op*. *Cit*.

15/ Bartlett, *Op*. *Cit*., p. 22.

16/ *Economic Report of The President*, February 1975, p. 185.

17/ Ferguson, *Op*. *Cit*., p. 263.

18/ 1971 Report.

19/ Bartlett, Roland, "Fluid Milk Sales as Related to Demand Elasticities," Journal of Dairy Science, Dec. 1964, Vol. XLVII, No. 12, pp. 1314-1321.

20/ Leonard, Thomas, Government Regulation of Milk Markets, Staff Economists Mimeo, C.N.I. Conference.

21/ Ippolito, Richard, and Robert T. Masson, The Social Cost of Federal Regulation of Milk, Mimeo, C.N.I. Conference.

22/ Boehm, William, and Emerson Babb, Household Consumption of Beverage Milk Products, (Purdue Agricultural Experiment Station: Lafayette, Indiana, 1975) No. 75.

23/ Shaw, Op. Cit., p. 28.

24/ Staff Report to the Federal Trade Commission, Op. Cit., p. 77.

25/ California Department of Food and Agriculture, Op. Cit., pp. 1, 7, 21.

26/ Government's Role in Pricing Fluid Milk in the United States, Agricultural Economic Report #229, (G.P.O.: Washington, D.C., 1972) p. 17.

27/ Producer Milk Pricing In California, Legislative Analyst, State of California, (Sacramento, California, October, 1975) No. 75-19.

APPENDICES

APPENDIX A

STATE OF MONTANA
OFFICE OF THE LEGISLATIVE AUDITOR

TYPES OF MILK PRICE CONTROLS
MAY, 1976

	State	Producer Level	Resale Level Wholesale	Resale Level Retail	Prohibits Sales Below Cost
1.	Alabama	S	S	S	S
2.	Alaska	-	-	-	-
3.	Arizona	F	-	-	-
4.	Arkansas	F	-	-	S
5.	California	S	S	S	S
6.	Colorado	F	-	-	S
7.	Connecticut	F	-	-	-
8.	Delaware	F	-	-	-
9.	Florida	F	-	-	-
10.	Georgia	F	-	-	-
11.	Hawaii	S	-	-	-
12.	Idaho	F	-	-	S
13.	Illinois	F	-	-	-
14.	Indiana	F	-	-	-
15.	Iowa	F	-	-	-
16.	Kansas	F	-	-	-
17.	Kentucky	F	-	-	S
18.	Louisiana	F/S	S	-	S
19.	Maine	S	S	S	S
20.	Maryland	F	-	-	-
21.	Massachusetts	F/S	-	-	S
22.	Michigan	F	-	-	-
23.	Minnesota	F	-	-	S
24.	Mississippi	F	-	-	-
25.	Missouri	F	-	-	S
26.	MONTANA	S	S	S	S
27.	Nebraska	F	-	-	S
28.	Nevada	F/S	S	S	S
29.	New Hampshire	F	-	-	-
30.	New Jersey	F/S	-	S	S
31.	New Mexico	F	-	-	-
32.	New York	F/S	-	-	-
33.	North Carolina	S	-	-	S
34.	North Dakota	F/S	S	S	S
35.	Ohio	F	-	-	-
36.	Oklahoma	F	-	-	S
37.	Oregon	F/S	-	-	-
38.	Pennsylvania	F/S	S	S	-
39.	Rhode Island	F	-	-	-
40.	South Carolina	S	S	S	S
41.	South Dakota	F	S	S	S
42.	Tennessee	F	-	-	S
43.	Texas	F	-	-	-
44.	Utah	F	-	-	-
45.	Vermont	S	S	S	S
46.	Virginia	S	S	-	S
47.	Washington	F	-	-	-
48.	West Virginia	F	-	-	-
49.	Wisconsin	F	-	-	S
50.	Wyoming	S	S	-	S

S = State law or regulation
F = Federal Milk Market Order
F/S = Combination state law or regulation and Federal Milk Market Order

Source: Compiled by Office of the Legislative Auditor.

STATE OF MONTANA
OFFICE OF THE LEGISLATIVE AUDITOR
TRADE PRACTICE PROVISIONS OF STATES
JANUARY 1972

State	Sales below cost		Prohibits—				Rebates		Requires price filing		Sales below cost					
			Price discrimination		Discounts						Decided by a percentage markup	Allowed for—[1]				
	Wholesale	Retail	Wholesale	Retail	Wholesale	Retail	Wholesale	Retail	Wholesale	Retail		A	B	C	D	E
Alabama	X	X	X	X	X	X	X	X	—	—	—	—	—	—	—	—
Arkansas	X	—	X	X	X	—	X	—	—	—	X	X	—	—	—	—
California	X	X	X	X	—	—	[2]X	[2]X	X	[3]X	—	X	—	—	—	—
Colorado	X	X	X	X	—	—	—	—	X	[3]X	—	X	X	—	—	—
Connecticut	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
Idaho	X	X	X	X	X	X	X	X	—	—	X	—	—	—	—	—
Iowa	—	—	X	X	—	—	—	—	X	X	—	—	—	—	—	—
Kentucky	X	X	X	X	—	[4]X	—	[4]X	X	—	—	X	—	X	X	—
Louisiana	X	X	X	X	—	X	X	X	—	—	—	—	—	—	—	—
Maine	X	X	X	X	X	X	X	X	—	—	—	—	—	—	—	—
Massachusetts	X	X	X	X	—	—	—	—	—	—	X	X	—	—	—	X
Minnesota	X	X	X	X	—	X	—	X	X	—	X	X	—	—	—	—
Missouri	X	X	X	—	X	—	X	X	—	—	X	—	—	—	X	—
Montana	X	X	X	X	X	X	X	X	—	—	—	—	—	—	—	—
Nebraska	X	X	X	—	[5]X	[5]X	[5]X	[5]X	—	—	[6]—	—	—	—	—	—
Nevada	X	X	X	X	X	X	X	X	X	X	X	X	—	—	—	—
New Jersey	X	X	—	—	—	—	—	—	—	—	—	—	—	—	—	—
New York	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	X
North Carolina	X	X	X	X	X	X	—	X	X	X	X	—	—	X	X	X
North Dakota	X	X	X	X	X	X	X	X	—	—	—	—	—	—	—	—
Oklahoma	X	—	X	—	—	—	—	—	X	—	—	X	—	—	—	—
South Carolina	X	X	—	—	—	—	X	X	—	—	—	—	—	—	—	—
South Dakota	X	X	X	X	—	X	X	X	X	X	X	—	—	—	—	X
Tennessee	X	X	X	X	[7]X	—	[7]X	—	X	X	[8]X	X	X	X	X	X
Vermont	X	X	—	—	—	—	—	—	—	—	—	—	—	—	—	—
Virginia	X	X	—	—	—	[9]X	—	[9]X	—	—	—	—	—	—	—	X
Wisconsin	X	X	X	—	—	—	—	—	—	—	X	X	X	X	X	X
Wyoming	X	—	X	—	X	—	X	—	—	—	—	—	—	—	—	—

X = Yes; — = No.

[1] Sales below cost are permitted (A) to meet competition, (B) for government contracts, (C) for liquidation, (D) for damaged goods, and (E) for other reasons.

[2] If secret or unearned.

[3] Only home delivery.

[4] 3 percent allowed on drop delivery. More if justified at a hearing.

[5] If below minimum cost.

[6] Retail cost determined by markup from minimum base cost.

[7] Allowed if posted.

[8] In absence of lower retail costs.

[9] If below established minimum price.

Reprinted from: U.S. Department of Agriculture, Economic Research Service, Agricultural Report No. 229, Government's Role in Pricing Fluid Milk in the United States, July, 1972.

AGENCY REPLIES

State of Montana
Thomas L. Judge
Governor

Department of Business Regulation
Harold Pitts, Director
805 North Main, Helena, Montana 59601
Telephone 449-3163

November 29, 1976

NOV

Morris L. Brusett
Legislative Auditor
Capitol Building
Helena, MT 59601

Re: Your "Report on the Need For Milk Price Regulation in Montana."

Dear Mr. Brusett:

Our remarks will generally be confined to your recommendations beginning on page 89 of the referenced report.

However, we would like to make a general observation that there are just as many and more persuasive agruments for continuing the present pricing program than you have used to arrive at your recommendation that resale pricing be scrapped. *1*

It appears to the department that your staff assumed a position at the outset of your study and then adopted those arguments that supported your position while abandoning arguments that opposed it. New Jersey's information is used as an example. *2*

It also must be pointed out to the legislature what will happen in the industry if your recommendations are endorsed and carried to their full conclusion by the legislature as a whole. *3*

It is a foregone conclusion that all the independent handlers will fall by the wayside with the abandonment of resale pricing at both the wholesale and retail levels. In addition about fifty (50) jobbers (independent milk wholesalers and retailers) are immediately out of business because they are unable to compete.

With the loss of the five independent milk processors at least fifty (50) dairy farmers will lose their market, many of whom will be unable to find a new market due to geography.

CHAPTER III

With the above observations as background the department makes the following comments on your recommendations beginning on page 89:

1, 2, 3: See corresponding notes under Auditor Comments beginning on page 110.

CENTRALIZED SERVICES DIVISION
ISABELLE PISTELAK ADMINISTRATOR
WEIGHTS AND MEASURES DIVISION
GARY DELANO ADMINISTRATOR
FINANCIAL DIVISION
T. W. ALKE ADMINISTRATOR
MILK CONTROL DIVISION
K. M. KELLY ADMINISTRATOR
CONSUMER AFFAIRS DIVISION
DICK DISNEY ADMINISTRATOR

1. (a) Whether we could support legislation to repeal mandatory pricing provisions would depend on the legislation as finally drawn. We could support leaving it to the Board of Milk Conrol as to what prices at what level could be suspended.

   (b) We could support legislation to prohibit sales of milk below cost if such legislation was made a part of the Milk Control Law and costs of doing business were defined and whose costs should be used and the cost burden of proof be placed on the seller.

   (c) The department would support standby powers in extremeситutations only if such situations were defined and only as a last resort. As stated in (a) vesting the board with the authority to determine when and what prices are to be suspended would be more acceptable.

   (d) The department supports without qualification the recommendations that all retailers of milk be licensed. Our reasons for enthusiastic support of this recommendation are based on our experience that most violations of unfair practises start at the wholesale level. Milk distributor's in many instances are offered special consideration, by retailers, such as increased shelf space in return for special prices, equipment or other devices. See page 83, 84 and 85 of your report.

2. The recommendation to discontinue the setting of resale prices in an orderly fashion would be supported only as a last resort and if we had no other choice. Reference (a) above.

3. The recommendation to conduct an aggressive and routine program of investigation and enforcement against unfair competive practices in the milk industry is supported without qualification and is now being done consistent with authorized manpower. We could improve this program only by assigning a full time trained investigator to the program.

CHAPTER IV, page 101

The department generally supports the recommendation that some system of checks and balances should be employed to measure the effectiveness and the accuracy of the producer formula. Determining producer costs would be one method.

The legislative auditor is advised that a study of butterfat testing was conducted by the Milk Control Division during 1974 and results were presented to House Speaker McKittrick at the start of the 1975 session.

That study generally criticized the present methods of sampling and testing but no action was taken by the legisalture to change present methods or the authority to perform such tests.

It is our opinion that the Department now has the broad delegated authority to test milk for the purpose of pricing but specific authority in our present statute would eliminate anticipated argument.

We would like close with the observation that we enjoyed working with your staff and although we disagreed on theory and practice many times over the four (4) years this study was in progress, your people were very courteous and professional at all times.

Sincerely,

Harold Pitts
Director

HP/slm

AUDITOR COMMENTS

1. The administrator of the Milk Control Division has been aware of the potential position of the Office of the Legislative Auditor for some time and was given continuous opportunity to express his views on numerous occasions, particularly in the draft stage of our report process when he was provided a preliminary draft of the report. The administrator refers to "many and more persuasive arguments". Virtually all of these arguments have been thoroughly considered and addressed in the text of the report. One issue not addressed is the possible impact of the recommendations on "jobbers" or contract distributors. After consideration of this issue the potential impact does not alter our recommendation.

2. The audit was undertaken to evaluate and assess the efficiency and effectiveness of the entire milk price regulation program. As the audit progressed it became evident from the preponderance of

evidence that the effectiveness and continued need for certain facets of the milk price regulation program were questionable. During the course of the audit virtually every conceivable argument, pro or con, was sought out and evaluated. Preliminary drafts of the report were circulated to virtually all parties who had an interest in milk price regulation. The points raised by these parties were thoroughly evaluated in the formation of the final report and in most cases are specifically addressed in the final report. We are aware of no information which would alter our recommendations.

The issue of what might happen in the milk industry was a primary concern during the audit and is extensively addressed in the report. Whether or not the absence of resale price controls would benefit or adversely affect independent processors is unknown for certain since Montana's milk industry has been under rigorous price control for over 40 years. Even with such rigorous price controls, independent processors have been going out of business--the latest in November 1976--since the report was drafted.

The comment regarding jobbers is also speculation. The jobbers are not addressed in the report but after consideration we do not agree with the impact suggested by the department. Most jobbers are located in smaller communities where milk will continue to be demanded and where price competition is not anticipated.

Finally, the probable impact of the recommendations on producers was also evaluated and addressed in the report. The demand for milk will continue and possibly rise without resale price controls. While it may be possible that present producer-processor/distributor relationship may shift, there is evidence that the elimination of price controls will significantly benefit producers and consumers.

msu
DEPARTMENT OF AGRICULTURAL ECONOMICS
& ECONOMICS

COLLEGE OF AGRICULTURE
AND
COLLEGE OF LETTERS & SCIENCE
MONTANA STATE UNIVERSITY
Bozeman, MT 59715

December 6, 1976

Mr. Morris L. Brusett
Legislative Auditor
Office of the Legislative Auditor
State Capitol
Helena, Montana 59601

Dear Mr. Brusett:

The Board of Milk Control was not able to reach a consensus with respect to your report to the Legislator during our December 4 meeting. For this reason each of us have agreed to send you our own individual reaction to your report.

I support the recommendations to this report with respect to resale pricing of milk with the following qualifications and additions:

1. In recommendation 1(C) you recommend that standby authority be granted for resale price control. I concur with this recommendation. If this authority is granted, it is my opinion that the board should be required to develop specific criteria for use of this standby authority prior to any event which might lead to use of this authority. There are two reasons for this suggestion. First of all, if such criteria are developed, it should be possible to exercise the authority without the necessity of a public hearing and the accompanying long time delay before such authority can be exercised. The second reason for this suggestion is to avoid the possibility of a return to our present price structure simply as a result pressure from the milk distributors.

2. In recommendation 2 it is suggested that the setting of resale prices be discontinued in an orderly fashion. I concur with this recommendation but I suggest that the legislators specify a definite time period within which this should be accomplished.

3. I support your recommendation 3 with respect to investigation and enforcement against unfair competitive practices. I suggest however that this recommendation be directed to the Department of Business Regulation rather than the Board of Milk Control.

STATE AGRICULTURAL EXPERIMENT STATIONS
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I do not support your recommendation with respect to gathering of additional data on the cost of production as a check on the operation of our producer formula. It is very difficult to use cost of production as a basis for determining price for the following reasons:

1. Some costs are a function of price. An example of this is the dairy cow herself. The higher the price of milk, the higher the price of cows is likely to be, thus the higher the cost of producing milk is likely to be. Thus, you can see that if the cost of production is to be used as a basis for establishing the price of milk, one immediately gets into a vicious circle in which higher prices induce higher cost, which in turn induce higher prices, etc., etc.

2. One must determine whose cost of production to use in establishing price. If we had 250 dairy farmers in Montana, I would expect to find 250 different costs of producing milk, thus if cost is to be the foundation on which price is determined the critical question is, whose costs?

For the above reasons, all accounting records of costs are suspect as a basis for establishing the price of milk. For this reason I would not consider it appropriate to use Milk Control Board funds to pay for regular extensive cost surveys. It does seem appropriate to examine cost submitted by the industry or by the extension service when such data are presented in public hearings. Even in such cases, however, it is appropriate for the board to consider such evidence with a great deal of caution.

Your final recommendation with respect to the producer price formula relates to the testing of milk. I suggest that this recommendation be worded in such a way as to leave the door open for component pricing of milk. Butterfat is only one of the valuable nutrients in milk and it seems desirable that the producer would be paid for other nutrients in addition to butterfat which they produce. Furthermore, the reasoning leading up to this recommendation infer that our present system of pricing encourages the production of high butterfat milk. I believe this not to be the case. A 7.5 cents per 1/10 percent butterfat differential which is used currently is lower than the market price of butterfat. I believe most people familiar with the dairy industry would agree that the use of this differential gives an advantage to the producer of lowfat milk.

With the above modifications I support the recommendations you have made with respect to modifications in the law governing the operation of the Board of Milk Control.

Sincerely,

Edward H. Ward
Professor and Member of
The Board of Milk Control

EHW/jf

Enclosure

December 5, 1976

Morris L. Brusett
Legislative Auditor
Helena, Montana 59601

Dear Mr. Brusett:

Herewith is our reply to your report on the need for milk price regulation in Montana:

Page 89 -(1) (a) - We cannot honestly support legislation to repeal the mandatory provisions of the current law. The Milk Control Board is charged with the responsibility of providing supervision and regulation of the milk industry in Montana at producer, wholesale and retail levels and it is our firm belief that these functions should be continued. We feel that the formulas now being used are achieving the desired results without disruption at all levels. As evidence of this, we point to both increased production and increased consumption of milk as outlined in most recent reports of "Reported Producers Receipts and Reported Class I package sales." These reports indicate to us that reasonable returns are being realized at all levels and that retail prices are acceptable to the consumers. The conclusions reached in your audit report concerning conditions prevailing in the states of New Jersey and Virginia were not confirmed but were refuted by officials of these states that we personally talked to at a recent national meeting in Virginia. We further believe (and testimony introduced in recent hearings has also indicated) that removal of resale price controls would cause a price war which would result in the eventual elimination of our present independt milk processers and independent handlers, as well as the producers now supplying these markets. After such elimination, the price to the consumer would then rise to levels above those prevailing before the controls were removed, and would very likely lead to a situation where consumers in sparsely populated areas (and we have many of these in Montana) would have no source of supply whatever. 1

Page 89 (1) (b) - This sounds good on paper, but records are such that it is virtually impossible to determine costs accurately, so how could anyone prohibit sales below cost in such a situation? The costs that have been discussed in hearings conducted by our Board in recent years have been so varied that a general determination of such costs would be meaningless.

Page 89 (1) (c) - Here again this sounds good on paper, but would be impractical. We have five members on our Board and we do not agree on all matters, so what some members might consider an extreme situation, other members might have a different idea. By the time this impasse was resolved, plus the time required to get the standby powers implemented, it would probably be too late to save the industry.

Page 90 (1) (d) - This is a good recommendation and should be followed.

Page 90 (2) - Our comments under Page 89 (1) (a) cover this recommendation. We would sincerely hope that no new legislation would be introduced that would disrupt the satisfactory situation that prevails at the present time.

Page 90 (3) - We feel that the department is now conducting and will continue to pursue their agressive program of investigation and enforcement against unfair competitive practices in the milk industry.

In conclusion (regarding the audit report as it refers to the above portion of same) it appears to us that your investigation reached a conclusion first and then proceeded to attempt to justify this conclusion. Many pages of the report are devoted to statements indicating that there is so much profit in the distribution sector that these costs are not carefully monitored. It is suggested that these costs would be substantially reduced by the elimination of resale pricing. These statements are not substantiated by facts, and we find it hard to believe that any business would knowingly waste money on any segment of their operation. If this practice were continued for very long, such firms would be out of business with or without controls, and we would not have to worry about them anyway.[2]

Page 101 (Chapter IV) - The Montana Milk Control Board is constantly working to update and improve our formuala price process. We will continue to do so, and will utilize all the actual data costs we can obtain from the Extension Service and/or any other sources available.

Page 103 (Chapter IV - We strongly disagree with your statement that the Board should consider the propriety of basing milk prices and payments on a system which induces the production of milk with a high butterfat content. As a matter of fact, the trend is (and has been for many years) toward the production of milk with a low butterfat content. This is the type of product the consumer wants and we should endeavor to furnish it. We feel that the existing statute is adequately handling this situation.

We have enough laws and statutes on our books now, especially when our industry is operating in a generally satisfactory manner at all levels. Let us leave it that way!!

Sincerely,

Genevieve Remillard
Genevieve Remillard, Board Member.
Rosemary Fiorentino
Rosemary Fiorentino, Board Member.
Kenneth Mortag
Kenneth Mortag, Board Member.

1, 2: See corresponding notes under Auditor Comments on page 117.

AUDITOR COMMENTS

1. The board members' reply refers to "the conclusion reached ..." in our report about New Jersey and Virginia. There are no conclusions reached in the audit report about New Jersey. The reference to New Jersey was an oversight, according to the board member who drafted the reply. The conclusions in the report concerning Virginia are based upon fairly recent correspondence with the administrator of the Virginia State Milk Commission. This official advised us that he "... would not attribute their closing solely to the elimination of the retail pricing in the state." This comment is paraphrased directly in the report.

The report does not contend that there are excessive profits in the distribution sector, but rather addresses, among other things, the efficiency and innovativeness of the distribution process. While there may or may not be unusual profits, that issue is peripheral to the basic question as to whether or not resale price controls are still necessary.

CURTIS C. COOK
ATTORNEY AT LAW
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TELEPHONE (406) 363-2700

December 9, 1976

Mr. Morris L. Brusett
Legislative Auditor
Capitol Building
Helena, Montana 59601

Re: Your "Report on the Need For Milk Price Regulation in Montana."

Dear Mr. Brusett:

Due to the fact that the Board of Milk Control of Montana, in convened session, found it was impossible to write a board report on the milk audit due to divergent opinions, I am sending my individual report for your consideration and to be included in the transmission to the Legislative Audit Committee.

I feel that the fixing of minimum prices throughout the milk industry has served a definite purpose in the past, and I feel that the establishment of true minimum prices which would require the distributors and retailers to have their own profit margins, would be beneficial from now on. However, since the industry is so completely opposed to this type of resale pricing, I am of the opinion that tne abandonment of resale pricing in Montana is indicated in the interest of the consumer.

At the time the audit report was first written, there were five independent milk processors in Montana and between that time and the present, one of them has sold out leaving only four independent processors. This was during a peroid when the minimum prices fixed by the formula mandated by the legislature and established by the board were favorable to all aspects of the milk industry. If the sale of the Hanson Plant at Great Falls had occurred after resale pricing had been discontinued, it would have been pointed to as an indication that the abandonment of resale pricing had forced an independent processor out of business. This cannot be the case and only indicates that independent processors are regularly leaving the milk industry regardless of resale pricing protection.

It is my opinion, that if resale pricing is abandoned the unfair practices aspect of the milk law must be reinforced and I would suggest that this be by special enactment within the milk field rather than by relying upon the general unfair practices acts.

I would suggest that there should be standby legislation which would allow the Board of Milk Control to resume whatever pricing control the board felt, in its discretion, was necessary under the particular circumstances and I think such standby legislation should not be tied in with the usual concept of an emergency, but should be specified for extreme conditions which are disruptive to the milk industry.

I feel that there should be some kind of supervision by the Board of Milk Control over the time and method of implementing new legislation which would do away with resale price controls, within guidelines to be set by the legislation.

I can find no merit in the suggestions at continuing cost studies be done by the Extension Service of the Montana State University as a means of providing feedback to the board in order to determine if the pricing set by formula is working. This type of cost information would be self-serving for the milk producers and would be suspect at best. Requiring producers to participate in such a system of cost studies would be one more example of bureaucratic interference with the small businessmen who are milk producers. Once the formula has been established and is apparently working, it can be checked by occasional hearings at which the producers can produce cost figures and at which other interested parties can also be represented. The procedure suggested by the audit report would preclude anyone else from having an opportunity to be heard as they now have at public hearing.

The report deals with butterfat procedures and suggests the impropriety of basing the prices and payments on butterfat content. I would like to suggest that the present trend in nutrition is to look at other food values in milk as more important than butterfat. I would suggest the legislation make it possible to include in the pricing of milk the other food values besides butterfat. There are testing procedures available for this area which would test protein, mineral, etc. Whatever basis is used for establishing the milk on basis of quality, whether it be butterfat or other food values, should be written into new legislation with safeguards which would prevent processors from manipulating prices to be paid producers by false reports as to butterfat content or other food values contained in the milk which go into the pricing system.

In conclusion, I would state that my position is as follows:

1. That resale pricing should be discontinued, with some control by the milk board as to the time and manner of actually eliminating the price control.

2. That the restrictions on unfair practices in the milk industry should be reinforced and should be within the Department of Business Regulation of The Board of Milk Control for enforcement. Licensing of all sellers of milk at wholesale or retail should be considered as an enforcement measure.

3. The Board of Milk Control should have some type of standby authority which would allow it to re-enter the resale pricing area in extreme conditions in order to prevent chaos in the industry and such authority should not be tied to the usual concept of emergency situations.

4. Any new legislation should provide some type of reinforcement to the control of payments based on quality of milk whether it be for butterfat content or for other food values which might be used in pricing.

In closing I would like to compliment the Legislative Audit Department on their handling of the audit procedure and in the report which resulted from the audit of the Milk Control Division. With this type of analysis the legislature will have a very definite advantage of considering any legislation with regard to the milk industry.

Sincerely,

Curtis C. Cook

CURTIS C. COOK
Member, Board of Milk Control

CCC/sw

Report under
separate cover.